DEPARTMENT OF THE TREASURY

National Treatment Study

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National Treatment Study

Report to Congress on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations

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THE SECRETARY OF THE TREASURY
WASHINGTON

November 30, 1990

The Honorable Dan Quayle
President of the Senate
Washington, D.C. 20510

Dear Mr. President:

Pursuant to the Financial Reports Act of 1988 (Pub. L. 100-418, sec. 3601, *et seq*.; 22 U.S.C. 5351 *et seq*.), I am pleased to submit the "1990 Report on Foreign Treatment of U.S. Financial Institutions." This Report updates and expands upon the National Treatment Studies completed by the U.S. Treasury in 1979, 1984, and 1986. The 1990 Report examines the degree of national treatment afforded U.S. financial institutions in twenty-one banking and eighteen securities markets. (For convenience, the conclusions of the foreign banking and securities chapters have also been placed at the front of the Report.) As specifically requested, the Report also addresses, for the first time, U.S. Government efforts to remove barriers in those markets and reviews the presence and treatment of foreign firms in the United States.

Progress in reducing barriers abroad is occurring at a varied pace, but generally not as rapidly as we would like. Significant improvements have been made in Canada and in many European countries. Only modest progress has been made in many Asian economies. Numerous Latin American countries still maintain restrictive financial systems. Thus, while notable strides have been made in opening and liberalizing many markets, the pace and degree with which this has occurred in other regions has been slow. The U.S. Treasury will continue to pursue vigorously its efforts to remove remaining obstacles to national treatment for U.S. financial firms operating abroad.

Sincerely,

Nicholas F. Brady

Enclosure

THE SECRETARY OF THE TREASURY
WASHINGTON

November 30, 1990

The Honorable Thomas S. Foley
Speaker of the House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

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PREFACE

I. Financial Reports Act of 1988

The 1990 National Treatment Study is required by the Financial Reports Act of 1988 (Pub. L. 100-418, sec. 3601 *et seq.*; 22 U.S.C. 5351 *et seq.*).

The 1990 Report expands upon national treatment studies completed in 1979, 1984 and 1986. The Financial Reports Act of 1988 instructs the Secretary of the Treasury to report to the Congress every four years beginning December 1, 1990, on foreign financial institutions in the U.S. and the kinds of services they offer, and the extent to which foreign countries deny national treatment to U.S. banks and securities firms, including U.S. efforts to eliminate discrimination. Thus, the 1990 National Treatment Study will report for the first time on the presence and activities of foreign providers of financial services in the United States.

The Financial Reports Act of 1988 also instructs the President or his designee, when advantageous, to conduct discussions with the governments of countries that are major financial centers. These discussions are aimed at: (1) ensuring that U.S. banks and securities firms have access to and receive national treatment in those markets; (2) reducing or eliminating barriers to, and other distortions of, international trade in financial services; (3) achieving reasonable comparability in the types of financial services permissible for financial services companies; and (4) developing uniform supervisory standards for banking organizations and securities companies, including uniform capital standards. The 1990 National Treatment Study also reports, for the first time, on the progress of these financial market discussions.

II. Scope of the Study

The Office of the Assistant Secretary for International Affairs (OASIA) of the Treasury Department and the Office of the Comptroller of the Currency (OCC) had responsibility for the preparation and production of the entire report. (Appendix II, Acknowledgments, indicates the principal drafters and editors of individual chapters.) The National Treatment Study primarily covers major financial markets which have significant denials of national treatment although some markets which have achieved substantial progress are also included.[1] The Treasury Department and the OCC solicited U.S. private sector views through a notice in the August 25, 1989, Federal Register.

The study covers 21 banking and 18 securities markets in 27 countries or regions. These chapters incorporate private sector remarks. The chapters were also sent to financial and monetary authorities in each market for comment and review. The final report, however, reflects the views of the U.S. Treasury Department. Sixteen of the banking markets and eight of the securities markets were reviewed in the 1986 Update. The banking markets reviewed in 1986 include Argentina, Australia, Brazil, Canada, Finland, India, Japan, the Republic of Korea, Mexico, Norway, the Philippines, Singapore, Sweden, Taiwan, Thailand, and Venezuela. New banking markets include China, the European Community, Indonesia, Turkey and the USSR. Securities markets covered in 1986 include Canada, Japan, France, the Federal Republic of Germany, Italy, the Netherlands, Switzerland, and the United Kingdom. Securities markets reviewed for the first time include Argentina, Brazil, the European Community, Finland, India, the Republic of Korea, Mexico, Singapore, Taiwan and Venezuela. The European Community chapters are based upon the actual or proposed legal framework which is to take effect on January 1, 1993.

The 1990 National Treatment Study is broader than previous studies in its coverage of the foreign presence in the U.S. market and the more detailed descriptions of foreign markets. Previous national treatment studies focused on the presence and treatment of U.S. firms in foreign markets. The 1990 study describes the structure and size of domestic markets, the regulatory regime of the host country, the presence of U.S. and other foreign firms, and the treatment accorded these firms. In addition, the U.S. section addresses a broader range of services than previously covered. It also reviews financial market talks the U.S. Treasury has had with foreign officials.

The study is current as of June 30, 1990. Where possible, developments since that date have been incorporated.

III. Earlier National Treatment Studies

This Report should be viewed as an expanded successor to the 1979, 1984 and 1986 studies. The general conclusions and individual market assessments of these three works provide an analytical framework to measure progress in achieving national treatment in banking and securities, both globally and in individual markets.

The 1979 Report, commonly referred to as the National Treatment Study, was mandated by Section 9 of the International Banking Act of 1978, which required the Secretary of the Treasury, in conjunction with the Department of State, the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, to conduct a study of the extent to which U.S. banks were granted or denied national treatment, whether by law or practice, in conducting banking operations abroad. The 1979 Report reviewed the degree of national treatment accorded U.S. banks in over 140 foreign banking markets, including in-depth analyses for 21 individual countries as well as the Andean Pact, COMECON, the European Community, and offshore banking centers.

The 1984 Update responded to a request from Senator Jake Garn, Ranking Republican of the Senate Committee on Banking, Housing, and Urban Affairs to Treasury Secretary Donald Regan for an update to the 1979 Report. Secretary Regan and Senator Garn agreed that the 1984 Update would be limited to a study of the 16 markets where U.S. banks desired an active presence but where national treatment was denied (to varying degrees) in 1979.

The 1986 Update responded to a request from Senator Garn to Treasury Secretary James A. Baker, III for an update to the 1984 Report. Senator Garn asked Secretary Baker to cover other segments of the financial services industry in addition to banking and to address electronic funds transfer systems in the study. The study reviewed progress in granting national treatment to U.S. banks in the 16 markets of the 1984 Update, as well as in two new banking markets. For the first time, the study also assessed securities markets, covering eight industrial country markets.

IV. Organization of This Study

The conclusions of the foreign banking and securities chapters, describing how U.S. financial firms have been treated abroad, have been placed at the front of this volume for the convenience of the reader.

Chapter 1 reviews the concept of national treatment including the evolution of the national treatment principle to "equality of competitive opportunity." The chapter discusses the application of national treatment policy under U.S. banking and securities laws, the Commodity Exchange Act and the key features of state insurance law. This chapter also analyzes for the first time national treatment as it applies to foreign participants in the U.S. futures and options markets and in the U.S. insurance industry.

Chapter 2 describes by nationality the origins of foreign financial institutions operating in the U.S. and the types of financial services offered by these firms.

The next section consists of chapters on 39 foreign markets. Chapters 3 through 26 cover 12 regions in which both the banking and securities industries are examined. Chapters 27 through 35 review national treatment for nine other banking markets. Chapters 36 through 41 analyze six additional securities markets.

Each banking and securities chapter consists of four main sections: Summary, Overview of the Domestic Market, Treatment of U.S. Financial Institutions and Conclusions. An additional section on Financial Market Discussions is provided where the Treasury Department has engaged in such discussions.

The Summary briefly describes treatment of foreign firms, including restrictions on entry and operations, notes recent national treatment developments and provides information regarding the presence of U.S. banks and securities firms in the particular market and the presence of banks from that market in the United States.

The Overview has two subparts:

0 "Domestic Banking/Securities Market" describes major features of the structure and regulatory regime of the

domestic banking system or securities markets, including the number and size of banks where available. Progress since 1986 is also noted in markets previously reviewed.

0 "U.S. Presence" indicates the number of U.S.-owned banks and securities firms and how they enter the market. The U.S. presence is compared with the foreign community as a whole.

The Treatment of U.S. Financial Institutions section analyzes national treatment in terms of entry and establishment, including branch, subsidiary or acquisition of equity in existing domestic entities, and operations, including any obstacles to full participation in all domestic financial market activity.

Financial Market Discussions report on efforts by the Treasury Department in selected countries to encourage foreign officials to liberalize their financial markets and provide national treatment to U.S. financial institutions.

V. Commitment to National Treatment

The United States has historically been a strong advocate of national treatment and the free international movement of goods, services, and capital. The International Banking Act of 1978 (IBA) adopted the policy of national treatment, defined as parity of treatment between foreign and domestic banks in like circumstances. In practice, the concept of national treatment has evolved from *de jure* national treatment to *de facto* equality of competitive opportunity. When implemented worldwide, national treatment, defined as equality of competitive opportunity, offers the best hope of achieving global economic efficiency and prosperity.

Although the principle of national treatment has evolved since its adoption in the IBA, the Treasury Department has traditionally opposed movement toward a reciprocity policy. Under Secretary Mulford, in testimony before the Committee on Banking, Finance and Urban Affairs of the United States House of Representatives on February 28, 1990, said:

> Over the past decade, the concept of national treatment has evolved from *de jure* national treatment to *de facto* equality of competitive opportunity. It is not

> sufficient simply to remove blatant discriminatory barriers. Foreign firms should effectively enjoy the same competitive opportunities as domestic firms. Despite moments of frustration and mounting pressure we have not strayed from this principle.

In testimony on April 5, 1990 before the Committee on Banking, Housing and Urban Affairs of the United States Senate, Treasury Under Secretary Mulford further elaborated, noting that:

> The U.S. objection to even limited reciprocity has been the risk that reciprocity will be used and that retaliation would follow. The impact could be devastating to confidence in world financial markets and established patterns of monetary and capital flows. The President has clearly stated his opposition to measures that might restrict the flow of capital or increase protectionism -- the marketplace should be free to allocate resources.

The Administration believes that the United States has been well served by our policy of national treatment. At home, the U.S. domestic market has benefited. Abroad, some significant strides in opening foreign markets have been made, although often as a result of arduous negotiations.

Problems arise when some countries keep their borders open to foreign competition while others do not. The principle of national treatment was adopted in the IBA in the expectation that all nations would recognize the benefits of foreign competition and work toward ending discrimination. While many countries have opened their markets many have also adopted reciprocity powers.

VI. Reciprocity vs. Equality of Competitive Opportunity

As of mid-year 1990, several EC countries were adopting some type of reciprocity powers to use if necessary in order to ensure national treatment for their financial firms. In his April 1990 testimony before the Senate Banking Committee, Under Secretary Mulford noted that in this regard the U.S. was increasingly in a minority:

> For example, in 1984, the OECD found that 11 of the 24 OECD members had some form of reciprocity powers available. Since then, other countries have added

> reciprocity powers. With the adoption of reciprocal national treatment that will become operative on January 1, 1993, under the EC's Second Banking Directive, at least 18 out of 24 OECD members will have reciprocity powers. We have pressed our concerns about the consistency of these new reciprocity measures with OECD members.

Of the 27 countries in this study, at least 13 employ reciprocity measures in banking and/or securities. (Some of the remaining countries impose even stricter entry restrictions.)

Nevertheless, in his February 1990 testimony before the House Banking Committee, Under Secretary Mulford underscored the benefits a policy of national treatment can provide:

> The policy of national treatment has attracted business, capital, talent and brain power to the United States. It has helped us to fund and develop our domestic and international financial market activity. It has helped us to press successfully for more liberal and open markets overseas. I do not believe a policy of reciprocity would have brought these benefits to the U.S. market. It could have kept foreign firms out.

However, the U.S. has also repeatedly stated that it will not hesitate to take vigorous action to promote or protect U.S. interests abroad if efforts to obtain national treatment fail. Because of the movement towards reciprocity or reciprocal national treatment in many other industrial countries and the slow progress in achieving effective national treatment, especially in some Asian and Latin American financial markets, Members of Congress have raised the need for possible tools to increase the effectiveness of achieving U.S. policy objectives within the framework of national treatment and equality of competitive opportunity.

VII. Foreign Financial Firms in the U.S.

The United States has one of the most open and competitive markets for financial services in the world. More than 719 foreign banks operate in the United States representing 284 bank families. Foreign bank representative offices as of August 31, 1990, totalled 453, representing 59 countries. By comparison, at year-end 1989, U.S. banks had 819 branches and 553 subsidiaries in more than 70 countries.

At the end of 1989, the SEC estimated the number of registered broker-dealers in which foreign persons have equity interests of 25 percent or more at approximately 130. The total may include companies doing business in the U.S. from abroad. Approximately 200 foreign investment advisors and four foreign investment companies are registered with the SEC.

The Commodities Futures Trading Corporation indicated that as of September 1989, foreign-based registrants consisted of 46 commodity trading advisors, 18 commodity pool operators, and three introducing brokers and futures commission merchants.

U.S. insurance affiliates of foreign direct investors received approximately $33 billion of premiums in 1987, or about 8.1 percent of total U.S. premiums, according to the Department of Commerce. The foreign market share of the U.S. insurance industry has greatly expanded since 1987, largely due to acquisitions of U.S. operations.

VIII. National Treatment at the Sub-Federal Level

The role of political subdivisions in determining which foreign banking or securities firms will be admitted to do business can complicate the ability of a country at the federal level to offer national treatment. For example, in Canada, the securities industry is regulated primarily by the provincial governments, while the Federal Government regulates other aspects of the financial industry.

Similar situations in banking exist in the United States, where some individual states limit foreign participation to less than the treatment accorded by federal law. Generally, these rules also impact domestic banks headquartered in other states. For example, branching prohibitions in most cases apply equally to foreign banks and to out-of-state U.S. banks. However, regional compacts among U.S. states have introduced elements of discrimination against foreign banks established in one of these states by not allowing them to do business in another compact member state although domestic banks may do so.

This situation results from the dual banking system in the United States, whereby banks have the option of a state or federal charter, and states may to a large extent determine their own banking structure. However, the adoption of an explicit policy of national treatment at the federal level has led some states to adopt more liberal policies regarding foreign bank entry. Under the IBA, foreign banks may, by obtaining a federal license, enter through a branch in any state that does not expressly bar foreign bank entry. A foreign bank also has the option to enter any one state by establishing a national bank. Hence, foreign banks are not denied entry absolutely, but their form of entry depends on state law. In addition, when foreign banks have approached the Treasury Department with concrete problems in entering a particular state, Treasury officials have generally been able to gain access for those foreign banks by contacting the relevant state authorities.

IX. General Observations

U.S. Government efforts through bilateral and multilateral channels have contributed to much of the progress noted in this Report. The U.S. Government has conducted discussions bilaterally with Canada, the European Community, the Republic of Korea, Japan, Venezuela, Mexico, with authorities on Taiwan, and with officials from other countries. The U.S. has also encouraged greater liberalization and equality of competitive opportunity in banking and securities markets in multilateral fora such as the Organization for Economic Cooperation and Development (OECD), the World Bank and the International Monetary Fund.

Despite outstanding problems, important strides have been made in opening and liberalizing Japanese financial markets under the rubric of the U.S.-Japan Working Group on Financial Markets. Discussions were also important to the adoption of an approximate national treatment standard for non-EC firms in the European Community's Single Market for Financial Services. The U.S. Treasury's financial market talks with the Canadians resulted in a financial services section of the U.S.-Canada Free Trade Agreement, which took effect January 1, 1989. This agreement, the first bilateral agreement by either side to cover the entire financial sector, removed many discriminatory practices U.S. financial institutions previously encountered in Canada.

In general, significant improvements have been made in Canada, in many individual European countries, and potentially in the European Community (EC) under the Second Banking, the Investment Services and other financial directives. In the case of the EC, the greater scope of activity and liberalization will largely benefit financial subsidiaries of U.S. firms rather than their branches.

The U.S. Government has made only modest progress in newly industrializing economies, such as the Republic of Korea and Taiwan. The Treasury Department has encouraged liberalization in financial market talks particularly with counterparts in these two regions.

One disappointing area is the lack of progress in gaining access to financial markets in most major Latin American countries. As Under Secretary Mulford noted in his April 1990 testimony before the Senate Banking Committee:

> We will continue to urge financial market reforms and more liberal investment policies in Latin American countries, especially in conjunction with development bank lending. Some of these countries, such as Venezuela and Mexico, have adopted a new openness in trade which I hope will spread to their financial sectors. It is difficult to justify that major debtor countries receiving support from a variety of sources under the strengthened debt strategy should maintain financial systems that remain substantially closed to the world financial community.

U.S. Government efforts to improve treatment of U.S. banks and securities firms are supported by our efforts in the Uruguay Round to achieve a multilateral agreement on financial services with legally binding obligations calling for both market access and national treatment for financial institutions. Although OECD countries have already made considerable progress in this area, in large part reflected in commitments through the OECD Codes of Liberalization of Capital Movements and Invisible Operations, the Uruguay Round provides an additional opportunity to pursue liberalization in a wider range of countries, including the newly industrializing economies of Asia and Latin America.

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[1] Under the Primary Dealers Act of 1988, the Federal Reserve Board is required to determine whether U.S. firms operating in the government debt markets of certain foreign countries have "the same competitive opportunities" as the domestic firms operating in those markets. Information provided in this study on government debt markets in foreign countries does not supercede determinations made by the Federal Reserve in accordance with the Primary Dealers Act.

CONCLUSION:

SYNOPSIS OF NATIONAL TREATMENT DEVELOPMENTS

Banking and Securities

Argentina: (B) There is potential for improvement on entry, and only small deviations from full national treatment affect established banks. Foreign banks are not legally prohibited from entry or expansion although the Argentine Government is not accepting applications for new banks, domestic or foreign, because they believe that an excessive number of banks already exists. However, foreign investors can enter the Argentine market through the purchase of insolvent local banks.

Argentina: (S) There is no legal discrimination, but U.S. firms have expressed little interest. There are no laws that specifically discriminate against foreign firm participation in the Argentine securities markets, and U.S. firms appear to receive national treatment. However, the thin, low-volume market in an uncertain economic environment has resulted in little investor interest among foreign brokerage firms.

Brazil: (B) Treatment of foreign banks has regressed with respect to entry. A significant new denial of national treatment has been erected and an old one continues, although Brazilian authorities have recently undertaken some administrative actions that may permit domestic and foreign banks to broaden their activities. Pursuant to provisions in Brazil's 1988 Constitution, Brazil has a de facto ban on the right of entry of foreign banks as new branches or subsidiaries. The prohibition remains in effect unless new laws are promulgated authorizing entry of foreign banking institutions. Those foreign banks already established in Brazil (of which three are U.S. banks) are, in turn, barred from offering basic personal savings accounts and are also prohibited from acting as the Government's agent for collection of taxes and fees.

Brazil: (S) Regression: a significant new denial of national treatment has been erected and old ones continue. Foreign firms seeking to invest in Brazil's securities markets face a de facto ban on new entry based on provisions in Brazil's 1988 Constitution. The ban on new establishment may be modified or lifted by Congressional legislation. In addition, limits on foreign capital participation continue. Established foreign financial firms (e.g., Citibank and Chase Manhattan) are very active in securities trading and other financial services.

Canada: (B) Significant improvement in Ontario and in Federal review of applications for entry; most barriers to right of establishment and operations have been removed as a result of the U.S.-Canada Free Trade Agreement, except no branching is permitted. Canada eliminated its equivalent of the Glass-Steagall Act, opening the securities industry to banks. Consistent with the U.S.-Canada Free Trade Agreement (FTA), Canada eliminated the restrictions on establishing additional branches by U.S. bank subsidiaries and on the ability of U.S. parent banks to transfer capital to U.S. bank subsidiaries. A significant improvement, from the viewpoint of U.S. banks, has been the removal of quantitative restrictions on the growth of assets of U.S. banks in Canada (also an FTA measure). The most important remaining constraint is the inability of U.S. banks to set up branches in Canada.

Canada: (S) Significant improvement in Ontario and in Federal review of applications for entry. Ontario has permitted (for the first time in 20 years) the entry of foreign securities companies and eliminated restrictions on remaining grandfathered securities companies (of which there were two). At the federal level, grounds for blocking entry are restricted to prudential reasons. Finally, the Bank of Canada permitted six U.S. companies to become primary dealers in the Canadian government securities market.

EC: (B) Reciprocal national treatment for non-EC firms will apply under the Second Banking Directive. U.S. and other financial institutions have yet to operate under the Single Market legislation for banking which is to take effect January 1, 1993. The Second Banking Directive, the centerpiece of the legislation for banking, offers U.S. financial institutions reciprocal national treatment. (The U.S. strongly opposed an initial proposal which envisaged possible mirror-image reciprocity.) It appears unlikely that U.S. banks will be subject to sanctions under the Directive's reciprocity provision. With reciprocity remaining, however, it is not certain that the new environment will be completely free of discrimination. In the absence of Member State implementing legislation, there is a possibility that discrimination might occur in the future. Nevertheless, the EC maintains that it is prepared to offer U.S. banks national treatment provided that EC banks receive national treatment in the U.S. The Second Banking Directive provides for substantial liberalization of the operations of U.S. bank subsidiaries established in the EC and provides grandfathering to those established before 1993.

EC: (S) Reciprocal national treatment is incorporated in the proposed Investment Services Directive. Firms engaged in securities activities authorized under the proposed Investment Services Directive will, if the directive is adopted, receive national treatment, as will banks engaged in securities activities authorized under the Second Banking Directive. Both directives provide for national treatment of subsidiaries of non-EC institutions. The reciprocal national treatment provision is nearly identical in the two directives. Where the EC perceives that effective market access in a third country is not comparable to that in the EC, but national treatment is provided, the Community may seek negotiations to obtain comparable opportunities for Community investment firms. In these circumstances, the Commission reportedly would not be authorized to take punitive action to deny entry to a U.S. securities firm. U.S. securities sold cross-border into the EC will not be treated the same as securities of an EC-chartered institution. They will be denied the benefit of reduced costs in fulfilling disclosure (prospectus) requirements for stock exchange listings or public offerings of securities that is available to EC securities. The prospectus for EC securities must be mutually recognized by other Member States once approved by one Member State. For non-EC securities, approval and hence mutual recognition is not automatic, but remains at the discretion of each Member State. Equal treatment with EC securities is subject to bilateral negotiation of "reciprocal recognition" of disclosure requirements of a non-EC state.

Mutual funds of U.S. institutions sold cross-border to the EC will be subject to national regulation. Open-end mutual funds may be set up and approved for sale within the EC on the same basis as EC mutual funds and may be offered throughout the Community by firms authorized under the Investment Services Directive; however, distribution modes would remain subject to marketing rules and practices of the individual Member States.

Finland: (B) There has been continued improvement and movement toward full national treatment although some constraints remain. Foreign banks were not allowed in Finland prior to 1979; their presence is still very small. Liberalization of Finland's financial markets, underway since 1983, has continued in recent years, with a variety of steps to encourage a market-oriented evolution of Finland's previously limited and tightly controlled financial sector. Deregulation of limits on call market interest rate spreads in 1986, followed by the introduction of CDs in 1987, contributed importantly to a well-functioning interbank money market. Nevertheless, Finland has not been a profitable market for U.S. banks. Pending legislation would permit the establishment of foreign bank branches in 1992 (presently only foreign subsidiaries are permitted); however, this legislation contains a reciprocity establishment provision. In addition, the Government has indicated its unwillingness to permit foreign acquisition of a controlling interest (more than 20 percent) in an established domestic bank.

Finland: (S) There has been significant improvement toward full national treatment. Substantial liberalization of securities markets has occurred in recent years. Regulatory changes in 1987-88 opened the way for CDs, commercial paper, and mutual funds; relaxation of capital and foreign exchange controls opened access to foreign capital markets and sharpened domestic competition. Any registered bank, foreign or domestic, may apply for a securities trading license. Pending legislation would permit direct foreign establishment of a securities firm, without the current intermediate step of establishing a Finnish banking subsidiary. The same legislation would also permit foreign branch establishment, subject, however, to a reciprocity provision.

India: (B) No improvement: significant denials of national treatment exist. Restrictions remain on entry and expansion of foreign banks. The number of foreign banks and bank branches allowed in India may be no greater than the number of Indian banks and branches which exist in that foreign country. Since India's state-owned banks find it difficult to compete abroad and therefore have few offices, reciprocity limits new entry and the expansion of U.S. and other foreign banks in India. Once in the market, however, foreign banks receive better than national treatment in some areas and less than national treatment in others. For example, foreign banks are only required to devote 15 percent of lending to government-determined priority sectors in contrast to 40 percent of all other bank lending. As noted, however, foreign banks are severely restricted in the number of branches they may have, while domestic banks are encouraged to open new branches. Nevertheless, once in the market, a foreign bank reportedly finds it profitable.

India: (S) Major denials of national treatment exist and no significant improvements have been made. For the most part, Indian capital markets are closed to foreign investors. Indian stocks are not listed or traded in overseas markets and foreign portfolio investors cannot operate freely in Indian markets. U.S. banks have been active in merchant banking and other investment services, but are constrained by the fact that they are permitted only a limited number of branches and are restricted by Glass-Steagall from trading in foreign securities. There has been some liberalization of investment in India by nonresident Indians (NRIs), however, including the floating of the India Fund, the India Growth Fund, the India Magnum Fund (SBI/Morgan Stanley) and the IS Himalayan Fund. U.S. banks have been allowed to set up overseas funds and other programs to attract NRI investment, but these have not been given the same tax concessions as the Government-owned funds. Merrill Lynch aided Unit Trust of India in floating the India Growth Fund. Other financial services companies are becoming interested in the Indian market, but present regulations limit their scope of activity.

Japan: (B) Despite modest improvements, a variety of factors have kept the Japanese banking market difficult to penetrate and the slow pace of liberalization and deregulation has provided domestic banks with an unfair competitive advantage over foreign banks both in Japan and globally. Foreign banks continue to find Japanese markets difficult to penetrate, particularly in traditional banking functions. Japan has continued generally to provide *de jure* national treatment for foreign banks and in a few isolated instances better than national treatment. However, a number of factors, including regulated interest rates, restrictive operating regulations, strong ties among related firms (keiretsu), excessive compartmentalization of financial markets and lack of transparency, effectively reduce foreign banks' competitive opportunities and in certain cases burden foreign banking firms disproportionately relative to domestic firms.

While Japan continues to liberalize domestic financial markets, the slow pace of reform has failed to keep up with developments in international financial markets. Foreign banks rely more heavily than their domestic counterparts on the domestic money markets for raising funds. While reforms have been made, money markets remain underdeveloped and unattractive due to restrictive regulations, a limited range of permitted instruments, and an array of taxes which encumber virtually every instrument.

Regulated interest rates (affecting roughly 40 percent of total bank deposits) reduce the average cost of funds to Japanese banks, in effect creating a subsidy which, on a consolidated basis, gives them an advantage over foreign banks in the Japanese market and allows them to tolerate narrower profit margins overseas, thus facilitating their expansion in these markets. The substantial amount of BOJ lending to Japanese commercial banks contributes to this funding advantage. Finally, foreign firms have experienced a lack of transparency in the GOJ regulatory process; participation in the rule-making process for new products, services and markets is limited and foreign firms are not systematically allowed early opportunity to comment on proposed rules.

Japan: (S) Full and easy access to the Japanese investor base and entire range of securities activities is still difficult despite continued efforts to open and liberalize Japanese securities markets which have resulted in greater participation by foreign firms. Japanese authorities have undertaken important market-opening measures in recent years. These include: broadening access to the government bond market (by increasing foreign firms' allocation in the underwriting syndicate in October 1988, and in April 1989 adopting a true price auction for 40 percent of 10-year issues, which was expanded to a 60 percent auction in fall 1990); increasing the number of seats on the Tokyo Stock Exchange in 1988 and 1990 (resulting in 10 seats for U.S. firms of the 25 foreign-owned seats on the 125 member exchange); introducing a variety of securities products in domestic and Euroyen markets (e.g., commercial paper) and incremental liberalization of the domestic corporate bond market (including expanding the list of eligible issuers, introducing bond ratings and initiating shelf registration); approval of some new products such as GLOBEX (Chicago-based electronic futures trading system); establishment of futures and options markets and broadening residents' access to those markets overseas; overhaul of securities firms' capital guidelines (to eliminate practical disadvantages foreign firms had faced); and periodic efforts to improve transparency (e.g., consulting with the foreign community regarding capital guidelines and changes in the domestic equity warrant market).

Nevertheless, foreign firms argue that problems remain that prevent them from achieving a comparable degree of success achieved in other markets. For example, they cite impressive track records in investment trust management and pension fund management in other markets. Yet despite recent regulatory changes to open those markets in Japan, subsequent implementing measures and entry criteria will effectively keep foreign firms' participation minimal. In addition, foreign firms have argued that a combination of Japanese laws and practices makes difficult both the introduction of new products into Japan and the ability of Japanese investors to access foreign markets and products abroad. Foreign securities firms have also maintained that foreign exchange restrictions, which apply to domestic securities firms as well, have unfairly placed them at a disadvantage since they prohibit foreign firms from efficiently offering innovative products and services at which they excel worldwide. At the May 1990 meeting of the U.S.-Japan Working Group on Financial Markets, MOF announced a variety of measures which, when fully implemented, should relax some of the restrictions on introducing new products, accessing overseas markets and offering foreign exchange services. Foreign firms have also cited difficulties underwriting and distributing domestic bond and equity issues. Finally, they maintain that problems pertaining to transparency (including the lack of a reliable consultation process) continue to place them at a disadvantage compared to their domestic counterparts.

In general, Tokyo is viewed as a key financial center, but one in which change has not kept pace with that in other major centers. By any standard of openness, Tokyo lags substantially behind New York and London. Moreover, as new markets and opportunities arise in Japan, the ability of foreign firms to use their expertise and take advantage of those possibilities is frequently hampered by the incremental market-opening approach Japanese authorities have adopted. Thus, despite significant steps forward, the process of creating a truly level playing field is far from complete.

Korea, Republic of: (B) Significant denials of national treatment continue, but improvements in access are promised for 1991. Nonetheless, U.S. and other foreign banks face serious discriminatory restrictions on their ability to establish and branch, obtain local currency funding, increase their capital, expand their lending operations, engage in the trust business, and have been denied access to cash dispenser and electronic funds transfer networks. While foreign banks do enjoy some privileges, existing restrictions on permissible activity and discrimination result in an overall denial of equality of competitive opportunity in the local market. Steps by the Government of Korea to reduce discrimination have generally resulted in reducing privileges formerly enjoyed by U.S. and other foreign banks, while the discriminatory restrictions remain. The ceilings on issuance of CDs and paid-in capital have been raised, but remain inadequate.

As a result, the ability of U.S. and other foreign banks to serve or expand their client base has eroded. The ROKG's tight regulatory controls over interest rates, credit allocation and foreign exchange operations apply to U.S. and Korean banks, but particularly disadvantage U.S. banks which could otherwise excel at introducing new financial products and services. Financial Policy Talks, initiated by the U.S. Treasury Department with the Korean Ministry of Finance, have produced expressions of willingness to address some of these denials of full competitive opportunity. Furthermore, the measures noted above in the November 28 communication from the MOF represent potentially useful measures to begin redressing existing problems. It will be important, however, to ensure complete articulation and follow-up on these and a range of additional significant steps before equality of competitive opportunity is realized.

Korea, Republic of: (S) Significant denials of national treatment exist and no meaningful improvement has occurred. To date, the Government's steps toward liberalization have been aimed at allowing Korean financial institutions greater freedom to exploit opportunities in the United States and other foreign capital markets. The Government of Korea's December 1988 revised plan for liberalizing its capital markets delayed until 1991-1992 the important steps of licensing U.S. and other foreign securities firms and allowing foreign financial institutions and individuals direct access to the Korean equities market. (The Government's original 1981 liberalization plan had envisioned completing these steps by the late 1980s.) Draft criteria for licensing U.S. and other foreign securities firms released in late November appear highly restrictive, as are existing criteria for approving new foreign bank branches. Moreover, important questions, such as equity composition and permissible activities, remain unanswered at this time. Observers fear that the range of permissible market opportunities may also be severely limited when foreign securities firms and other investors are allowed to participate directly in Korea's capital markets. Expansion of the closed-end equities funds, such as the Korea Fund, is a welcome development but does not constitute a significant improvement in foreign access to Korea's equities market. However, if the Korean Government carries through with the measures cited during the November 1990 Financial Policy Talks and the final criteria for establishment are appropriately adjusted, important improvements may be introduced over the next two years.

Mexico: (B) Despite steps to permit limited minority foreign investment in Mexican banks, significant denials of national treatment continue with only slight improvement foreseen. Mexico has been closed to foreign entry since the 1930s. The nationalization of the Mexican banking industry in 1982 reinforced barriers to direct entry. Legislation is now in effect which will permit majority ownership of commercial banks by the private sector. As part of this reprivatization program, foreign investors as a group will be allowed to own up to 30 percent of the banks to be privatized. Banks tend to conduct international activity through branches and wholly owned subsidiaries. Therefore, it remains to be seen if any U.S. banks will be interested in the Mexican reprivatization program, given the remaining limitations on foreign ownership and control.

Mexico: (S) Significant denials of national treatment exist in Mexico. Foreign commercial and investment banks may not establish branches or subsidiaries, although they may open representative offices. They may only engage in securities activities by purchasing a minority ownership of a brokerage firm or bank, or by using a local Mexican brokerage firm. Foreigners are, however, allowed to purchase most public and private sector instruments, but have limited opportunities to purchase stock directly, although they may do so indirectly through mutual funds or trusts.

Singapore: (B) Significant denials of national treatment remain in the domestic market and no improvement has been made. Foreign banks continue to hold a large share of the market and U.S. banks have a sizeable presence, but new entry by foreign banks and expansion of their operations is generally restricted. Fully licensed foreign banks have not been permitted to open new branches for several years. Depending on the type of license a foreign bank holds, it is subject to restrictions limiting its ability to compete for domestic banking business. Foreign banks have also been restricted from introducing new technology if local banks are not able to offer similar services. Singapore's offshore market, however, is significantly larger than the domestic market, and foreign institutions are granted national treatment in this market.

Singapore: (S) Despite some noteworthy improvements, important denials of national treatment still exist. As a matter of policy, Singapore has in the past strictly limited the activities of foreign firms in its securities market. The Government, however, has recently pursued measures to make Singapore a major international market and has thus recognized the need to tap the expertise of foreign firms. Since 1987, nine foreign securities firms have received permission to form joint ventures with local brokerages with equity limited to 49 percent. In October 1990, the Government announced it would allow foreign securities firms to increase their ownership to 70 percent in these nine joint ventures. When implemented, this will be a modest step forward. The foreign share of new joint ventures, however, will still be limited to 49 percent.

Taiwan: (B) While there has been some improvement, important denials of national treatment continue. On the whole, foreign banks are still denied national treatment in Taiwan. A number of steps have been taken since 1987, however, to liberalize the banking system and expand foreign banks' ability to compete on an equal footing with domestic banks. Given the recent announcement of these liberalizations, it remains to be seen if they will result in actual progress. With the implementation of the revised Banking Law in April 1990, foreign banks are to be permitted to engage in saving and trust activities. Some restrictions have also been relaxed on the entry of new foreign banks, the establishment of additional bank branches and foreign banks' ability to accept local currency deposits. Nevertheless, discrimination against foreign banks still remains in some of these areas, particularly regarding their ability to fund themselves competitively in local currency, the limitations on branching, and the inability to establish subsidiaries. Despite discriminatory treatment, the Taiwan market has been profitable for U.S. banks.

Taiwan: (S) Significant denials of national treatment exist despite minor improvement. There has been only minor improvement in Taiwan's treatment of foreign securities firms since 1986. Foreign securities firms are far from receiving national treatment. In February 1990, the authorities for the first time gave approval for two foreign (U.S.) securities firms to establish branches under strict qualifications. Otherwise, foreign firms are only permitted limited ownership in securities operations and may not establish subsidiaries nor enter into joint ventures. In addition, Taiwan prohibits direct foreign investment in local securities, the listing of foreign securities on the local market, and the offering of underwriting services by foreign firms.

Venezuela: (B) Significant denials of national treatment exist with only minimal improvement foreseen. Venezuela places severe restraints on foreign banks' establishment and operations. However, Venezuelan officials have recently acknowledged the need to modernize the country's financial system and have indicated that a gradual opening to foreigners will be permitted. In the context of a World Bank financial sector loan, the GOV announced plans to increase the permissible level of foreign equity participation in commercial banks from 20 to 30 percent and allow foreigners to purchase bank shares from Venezuelans rather than exclusively from foreigners. In 1990, foreign firms were allowed to own 100 percent equity in domestically incorporated nonbank financial services firms. It remains to be seen how these new developments will unfold in actual practice.

Venezuela: (S) Despite mixed results in movement toward national treatment, significant restrictions remain on the establishment of bank branches and subsidiaries. Foreign access, however, is relatively easy via representative offices, which may engage in a variety of consulting and investment advisory work. Foreigners can also purchase any amount of stock on the local exchange, except in the commercial bank sector, and may purchase a seat on the exchange provided the member company contains some minority local content. Foreign corporations based in Venezuela can now issue any type of stock, bond or commercial paper on the stock exchange after meeting national requirements. Some American firms interested in securities and investment banking maintain that they have been able to engage in some of these activities, primarily, however, from offshore or by using a local Venezuelan firm. The January 1990 promulgation of Decree 727 could result in greater direct foreign access to Venezuelan capital markets through the formation of wholly owned domestic subsidiary companies of a foreign financial institution. Although the local capital market has been small historically, the opening of the market to foreigners, the issuing of Central Bank zero-coupon bonds, and the privatization of state enterprises may expand this market.

Banking

Australia: While deregulation has continued, only limited additional progress toward national treatment has been made. Following significant improvement in 1985 when trading bank licenses were offered to five U.S. banks (four were utilized and three applications were denied), little additional progress has been made toward national treatment. Additional trading bank licenses are not expected to be offered to foreign interests in the foreseeable future although more limited licenses are available. Deregulation, however, has continued. The interest rate ceiling on new housing loans was removed in 1986; the savings bank reserve asset ratio was reduced in 1987; and the distinction between savings banks and trading banks was removed in 1989. With respect to nonbank financial institutions, the 50 percent limit on foreign ownership of money market dealers was removed in 1990 and the requirement that ownership be spread among several owners was abolished.

China, People's Republic of: There has been slight improvement, but significant denials of national treatment remain. Foreign banks' entry and operations in China are severely restricted. Foreign banks can only open branches in the five special economic zones and the Pudong area. They cannot take local currency deposits or provide local currency loans. Foreign banks may open representative offices in other areas, but they cannot engage in direct profit-making business.

Indonesia: There has been significant improvement with movement toward national treatment although some denials remain. Recent reforms in the banking sector permit existing foreign bank branches to expand and new foreign entrants to establish branches, provided they form joint ventures with existing national banks. While restrictions remain on capital requirements and some lending activities, foreign banks can conduct the same banking operations as domestic banks and lend to customers throughout Indonesia. In addition, in Indonesian securities markets, recent reforms in the stock exchange and bond markets have permitted the establishment of foreign joint venture securities houses which can act as stock brokers, traders and underwriters.

Norway: Significant improvement toward full national treatment has been made although some restrictions remain. After initial deregulatory moves in the mid-1980s permitting entry of foreign banks as subsidiaries, regulatory changes in February 1990 are expected to open the banking sector by allowing Norwegian subsidiaries of foreign banks to open branches and branches of foreign banks to be established (if authorities are satisfied with depositor protection). Moreover, the Government of Norway is considering permitting the purchase of local financial institutions by foreign banks from countries that grant this right to Norwegian banks. Also, subsidiaries of foreign banks have been granted securities trading licenses, which enable them to compete on an even footing with the local banks.

Philippines: Significant denials of national treatment, especially with regard to entry, remain with no improvement. Foreign bank entry into the Philippines remains limited to minority participation in domestic financial institutions and offshore banking units, and to representative offices in Manila. U.S. banks that were established before restrictions were introduced on new entries account for about one-sixth of the commercial banking market. They are, however, prohibited from opening new branches and offering trust accounts. Whether they will be able to establish automated teller machines off their premises remains to be seen.

Sweden: There has been important movement toward full national treatment as meaningful improvement continues. Foreign participation in Sweden's financial markets has been permitted since 1986. Following an official government report recommending extensive liberalization of Sweden's banking law (in the context of the European Community's Second Banking Directive), legislation was passed to effect these changes, including the opening of foreign bank branches. This law took effect in August 1990. In addition, by mid-1989 most remaining foreign exchange controls (dating from World War II) were abolished, thereby enabling foreign investors and institutions to acquire Swedish money market instruments and bonds. It appears there are no substantive constraints on foreign banks' activities in Sweden.

Thailand: Significant denials of national treatment remain and there has been no improvement. The treatment of foreign banks in Thailand has not changed since 1986. Foreign banks are still limited to only one branch office, and may not join a Thai ATM network nor initiate one of their own. Operations of foreign banks are also impaired by stringent loan to capital ratios based on branch capitalization and the requirement to invest their capital in low-yielding government securities. Moreover, a 10 percent withholding tax on foreign funds brought into Thailand is imposed on U.S. banks because of the absence of a bilateral tax treaty between the United States and Thailand.

Turkey: Foreign banks receive de jure national treatment. As a matter of law and policy there is no discrimination against foreign financial institutions. The establishment of banks and their operations are governed by the same laws and regulations that govern national banks. Despite equal status under the law, foreign banks are at the following financial and competitive disadvantages: the value of their capital, which is linked to legal lending limits, has been eroded by inflation; foreign banks cannot hedge inflation through revaluation of fixed assets (as their domestic competitors can) and they cannot use their global capital to meet lending limits; and finally, as borrowers dependent on the interbank market, they pay withholding taxes which puts them at a price disadvantage when on-lending, even though this cost may be credited against annual income taxes. U.S. banks in Turkey remain profitable, but are reexamining their options, including the possibility of converting branches to subsidiaries.

USSR: While foreign banks do not currently receive national treatment, liberalization is expected in the near future. U.S. banks may not operate in the domestic banking market of the Soviet Union. They may represent foreign clients through representative offices. There is no securities market in the Soviet Union.

Securities

France: Entry is easy and national treatment is accorded in almost all instances. French authorities are trying to attract foreign financial firms to France as part of a strategy to make Paris a major European financial center: foreign firms can now own French brokerages; 25 percent of the members of the French futures market are foreign firms; and foreign firms are authorized primary dealers. With elimination of all foreign exchange controls and the comprehensive deregulation of financial markets, France has become a more attractive, albeit more competitive, financial marketplace. U.S. financial institutions can enter the French securities markets on the same conditions as French firms by establishing a subsidiary or a branch (dependent on U.S. laws). Procedurally, they are treated differently when making acquisitions, since non-EC firms (defined as firms controlled by non-EC entities) must receive prior approval from the Ministry of Finance. French authorities bar U.S. firms from lead managing domestic French franc bond issues, as a reciprocity protest against Glass-Steagall restrictions on French banks operating in the U.S.

Germany, Federal Republic of: Entry is not restricted and foreign institutions generally are treated comparably to local firms, although in practice, increasing market penetration is difficult to achieve. Some operational restrictions impact on U.S. firms' competitive positions. The two most important concerns of U.S. financial institutions are data processing requirements and restrictions on operations of direct foreign bank branches. Branches may not participate in the federal bond underwriting consortium or lead manage foreign DM bond flotations in the FRG, although the same restrictions do not apply to subsidiaries. There are also unresolved questions concerning foreign branches' capital requirements, particularly for non-EC banks. In the federal debt market, the largest securities sector, foreign bank subsidiaries have substantially greater opportunity for the acquisition of federal bonds since the introduction of an auction technique in summer 1990. The language requirement for directors of subsidiaries also continues to concern some U.S. financial institutions in the FRG.

Italy: National treatment is generally provided and some minor improvements have been made. Although the Government of Italy (GOI) has adopted a more relaxed policy toward bank entry rules, reciprocity at establishment still applies. All foreign banks, which in Italy can engage in securities activities, can open branches throughout Italy and lending is no longer geographically limited. While capital requirements have eased for non-EC banks (lire 12.5 billion vs. previous lire 25 billion needed to establish a branch), EC banks will be relieved of this constraint consistent with the EC Second Banking Directive. Although neither foreign nor domestic corporations may operate as stockbrokers, this restriction disproportionately impacts on foreign firms. Pending legislation is expected to redress this.

Netherlands: National treatment is generally available to firms established in the Netherlands. Dutch financial markets are generally open to foreign firms. Securities regulations were eased significantly in 1986. Lead managing guilder-denominated bond issues, however, is subject to a reciprocity requirement, which does not appear to be a barrier for U.S. banks. Firms not incorporated in the Netherlands or another EC country face separate licensing requirements for securities-related activities and have limitations on their underwriting activities.

Switzerland: De jure national treatment is provided. Foreign firms are not generally constrained from doing securities business in the Swiss financial markets but some irritants cited. Despite the existence of some troublesome regulatory requirements, U.S. financial institutions have considerable operational opportunities in Switzerland which have been pursued vigorously. The opening of the "big banks" underwriting syndicate to foreign participation is a welcome move, even though U.S. firms are not involved. Restrictions on work permits for foreigners handicap all securities firms in Switzerland as does the tax on securities transactions.

United Kingdom: In general, foreign firms enjoy full national treatment and expanded business opportunities. Major market and regulatory changes in the U.K. since 1986 have significantly widened the range of business opportunities available to both domestic and foreign firms operating in the securities industry in Britain. The FSA has been implemented in a manner that has provided de facto national treatment to American firms. No bilateral problems have arisen with respect to the reserve reciprocity provisions of the FSA. Foreign firms, which were only beginning to be admitted to the stock exchange in 1986, are now widely represented on the exchange and are members of its executive board. An American is the head of the principal securities self-regulatory agency, TSA. U.K. regulators have taken the lead in establishing bilateral supervisory understandings with the SEC, the CFTC and the U.S. banking authorities. These have facilitated the smooth authorization of U.S. firms to operate in the U.K. consistent with the authorities' supervisory responsibilities under the FSA. Regulation has become more codified, more transparent and more expensive. The opportunities provided in the U.K. have been keenly competitive, particularly since the 1987 market decline. Aggressive expansion by American firms has been followed by some contraction and consolidation over the last two years.

1. National Treatment Under U.S. Laws and Regulations

Introduction

While there are exceptions, the prevailing policy of the United States has been to provide national treatment to foreign participants in the establishment and operation of financial institutions within the United States. Foreign-owned institutions provide services in banking, securities, insurance, and in the trading of options and commodity futures and option contracts. National treatment has provided foreign participants equality of competitive opportunity with domestic banks and investment firms operating within the structure of financial services laws in the United States, which separates commercial banking from investment banking and prohibits most underwriting and selling of insurance by banks and their affiliates.

This chapter begins with a review of the evolution of the principle of national treatment to the concept of "equality of competitive opportunity" as it was embodied in the International Banking Act of 1978 (IBA) and explained in the first National Treatment Study, published in 1979, "Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations."

To assess current treatment accorded to foreign-owned institutions providing financial services in the United States, the report examines the major features of financial institution supervision under U.S. banking, securities and commodity laws, and the key features of state insurance law. Where services are provided across borders, rather than by establishment, the report discusses the regulation of participants as well as regulations affecting the ability to introduce into the market securities and contracts on options and futures. Policies and proposals have been developed to facilitate transactions or give recognition to comparable regulation by foreign countries. Information provided in this chapter is current as of June 30, 1990, unless otherwise noted.

This chapter provides the first full study of national treatment as it applies to foreign participants in the U.S. options and futures markets and in the U.S. insurance industry. The 1986 Study addressed for the first time participation under U.S. securities laws. The discussion of banking and securities updates the 1986 Study, including the status of national treatment for commercial banking at the state level, national treatment as it is accorded to securities-related activities of banks and investment firms, the criteria for primary dealers in the government securities market, and regulation of securities activities at the state level. Discussion of national treatment as it is accorded to foreign participants in commercial banking in the United States was also provided in two previous studies.

The 1979 Report noted above should be consulted for expanded discussion of the IBA as well as concepts relating to restraints on competition, entry restrictions, and operating restraints applicable to U.S. banks in foreign markets.

Chapter 1 of the 1984 update of the 1979 Report summarized the concepts of national treatment and reciprocity from the earlier study, which are not repeated here.

Evolution of the National Treatment Concept

The concept of national treatment is not new. It has been employed, for example, in many of this country's bilateral treaties of Friendship, Commerce and Navigation (FCN) and in the 1976 multilateral Organization for Economic Cooperation and Development (OECD) Declaration on International Investment. While the OECD Declaration covers the treatment of established enterprises, the FCN treaties are intended to facilitate establishment of enterprises from one country within the borders of another and to create a framework for mutually beneficial economic relations between the signatory states. Recently, the OECD's Code of Liberalization of Capital Movements was amended to provide for the right of establishment of foreign direct investment.

The FCN treaties typically define national treatment of a foreign enterprise as:

> "treatment accorded (to it) within the territories of a Party upon terms _no less favorable_ than the treatment accorded therein, _in like situations_, to nationals, companies (or) products . . . as the case may be, of such Party." (Emphasis added)

National treatment in this sense, as in the OECD instruments, is not necessarily the same as assuring equality of competitive opportunity, since the latter requires a more comprehensive analysis of regulatory effects, recognizing differences in the circumstances of domestic and foreign institutions. The national treatment concept of the IBA and practical application of federal securities and commodity laws have established a broad federal policy of national treatment in the United States in terms of equality of competitive opportunity.

NATIONAL TREATMENT UNDER U.S. BANKING LAW

The IBA has established a federal regulatory framework governing entry and operations of foreign banks that is generally nondiscriminatory in its treatment of domestic and foreign banks and affords foreign banks equality of competitive opportunity compared with domestic institutions in similar circumstances.

Application of a policy of national treatment, as embodied in the IBA, entails a pragmatic assessment of the overall legal and regulatory climate affecting foreign banks in a given country. The test is met if foreign banks are allowed to compete on essentially equal terms with domestic institutions in the host country, even if some specific regulations or requirements applied to foreign banks differ from those applicable to domestic banks. Equality of competitive opportunity is a principle to be followed, not a numeric standard to be rigidly adhered to based upon the number of banks, offices, or assets of foreign versus domestic banks. Whether foreign banks, individually or as a group, are successful in taking advantage of competitive opportunities is not at issue.

The approach embodied in the IBA recognizes that rigid application of identical laws or regulations to both foreign and domestic banks may, in a particular set of circumstances, result in a disadvantage to one or the other. Equality of competitive opportunity may be lacking in some cases even though national treatment in a strict legal sense appears to be satisfied.

The IBA rejected a policy of reciprocity of national treatment whereby the United States would provide entry and national treatment only to foreign banks from countries providing U.S. banks entry and national treatment. (As discussed later, however, the ability of a foreign-owned company to act as a primary dealer in U.S. government securities is subject to a reciprocal national treatment standard.)

In the IBA, the U.S. Government established national treatment and equality of competitive opportunity for foreign banks operating in the United States, not only from the conviction that foreign bank competition is healthy for the U.S. financial system, but also from the conviction that those nations not previously extending national treatment would recognize the benefits of foreign bank competition and end discrimination against U.S. banks operating abroad.

Entry and Operations

Before passage of the IBA, the entry and operations of foreign bank branches and agencies in the United States were governed exclusively by state law. U.S. branch and agency offices of foreign banks were not eligible for federal deposit insurance and were not subject to U.S. reserve requirements. Enactment of the IBA established regulation of foreign banks at the federal level and implemented the principle of national treatment. Under the IBA, in those states that permit branch or agency operations, a foreign bank has the same option of choosing a state or federal license for branch or agency operations as is available for establishing a U.S. subsidiary bank, thereby enhancing the competitive opportunities available to foreign institutions. The IBA also provided U.S. branches of foreign banks the opportunity to apply for federal deposit insurance. Foreign banks have always had the power to engage in standard banking practices -- including transactions involving money market instruments, such as bankers acceptances and certificates of deposit (CDs), and various other instruments.

Board of Directors

The IBA also opened up some new competitive opportunities for foreign banks by ending the long standing prohibition against foreign citizens serving as directors of national banks. Foreign citizens can now constitute a minority of the board of directors of a national bank with the Comptroller's express approval. In addition to this, a significant number of states allow foreign citizens to be directors of state-chartered institutions.

Since enactment of the IBA, the principal vehicles through which foreign banks may enter the U.S. commercial banking market have been: (1) a commercial bank subsidiary chartered within the United States under either state or federal law; (2) a branch office licensed under state or federal law; (3) an agency office licensed under state or federal law and (4) an Edge corporation subsidiary chartered under federal law. Other vehicles for foreign bank entry include "Agreement corporations" organized under state law and subject to the Federal Reserve Board's Regulation K, investment companies organized under New York State law, and representative offices.

The IBA implemented national treatment in four other areas: interstate banking activities, nonbanking activities, reserve requirements, and ownership of Edge corporations, as discussed below.

Edge Corporations

The IBA permits foreign banks to own Edge corporations, which are entities chartered by the Federal Reserve Board (the Board) for the purpose of engaging in international or foreign banking or other international or foreign financial operations. Congress in the IBA also directed the Board to modify regulations applying to Edge corporations to make them a more flexible and attractive device for both domestic and foreign banks to provide international banking services in the United States.

Branch Capital and Reserves

The IBA requires that a federal branch of a foreign bank be operated under the same restrictions and conditions that would apply to a national bank operating at the same location. The Office of the Comptroller of the Currency (OCC) requires the parent bank to establish and maintain a capital equivalency deposit (CED) with a Federal Reserve member bank. CEDs are viewed as the functional equivalent of the capital accounts of a national bank and provide a cushion of protection for depositors and other creditors. There are no limits on lending based on the CED. Limits on lending and investment by the branch are based on consolidated worldwide parent capital.

The IBA gave the Board authority to impose reserve requirements on U.S. branches and agencies of foreign banks if the parent bank's worldwide assets exceed $1 billion. Foreign banks required to hold reserves are granted access to Federal Reserve facilities, including the discount window. Consequently, all depository institutions in the United States are subject to reserve requirements and have access to central bank services, including payments services.

Interstate Banking

Multistate branching and acquisitions by U.S. commercial banks are restricted by the McFadden Act and section 3(d) of the Bank Holding Company Act (the Douglas Amendment). Prior to the IBA, foreign banks had been able to establish branches and agencies in more than one state and had thus enjoyed a distinct competitive advantage over domestic banks. The IBA reduced that disparity by restricting the establishment of new domestic deposit-taking offices to the "home state" selected by the foreign bank but also allowed foreign banks to continue to operate existing branches wherever they had been established. Moreover, foreign banks may continue to establish new agencies and limited deposit-taking branches on a multistate basis.

Although the IBA did not alter the fact that establishment of branches by foreign banks is prohibited by law in some states of the United States, those states that are considered important major financial centers all permit foreign bank operation. (Even before the IBA most states did not restrict bank acquisitions by foreign banks.) In addition, regulations stemming from the IBA make it possible for foreign entities to establish a banking presence in states from which they were previously excluded entirely. For example, foreign banks may establish Edge corporations, which are not subject to restrictions on interstate branching. Foreign banks may also establish federally licensed offices in any state that does not specifically prohibit entry by a foreign bank.

Moreover, several states have liberalized their laws since 1978 with respect to foreign bank entry. Texas, for example, was an exclusionary state in 1978. In 1985, Texas enacted legislation permitting foreign banks to establish agencies. Texas enacted legislation effective January 1, 1987 to allow out-of-state financial institutions, including foreign banks, to acquire a Texas bank or holding company. Another example is Delaware, which in 1986 passed a law permitting foreign banks to open agencies in that state.

Regional Banking Compacts

Many states have entered into regional banking compacts that allow banking organizations from neighboring states to acquire banks in that state, but exclude all banking organizations from states not included in the region. Many of these compacts treat foreign banks in the same way as a domestic bank holding company located in another state within the region. A number of foreign banks have taken advantage of these types of compacts (e.g., National Westminster Bank, which has banks in New York and New Jersey; Bank of Ireland, which has banks in New Hampshire and Maine; and Royal Bank of Scotland, which has banks in Rhode Island and Massachusetts).

A minority of the states that have enacted regional banking laws preclude acquisitions by foreign banks whose home state is in a neighboring regional state. Such denial of equality of competitive opportunity by states undermines the IBA's policy of national treatment in such circumstances.

For example, Florida has enacted laws that permit a domestic bank holding company having the principal place of operations of its bank subsidiaries located in a state within the region to acquire a bank in Florida so long as reciprocity conditions are met. The same statute, however, prohibits a bank holding company that is, or that is controlled by, a foreign bank, including one having its IBA home state in a state within the defined region, from acquiring a Florida bank. Other states, for example, North Carolina, have removed such discriminatory provisions from their statutes.

Some states have enacted regional banking laws that, depending on interpretation of various provisions, would exclude foreign banks by defining a "regional bank holding company" eligible for interstate expansion within the region as a bank holding company that holds a large proportion of its total deposits within the region. The express purpose of these provisions is to prevent "leap frogging" by bank holding companies from outside of the region through the acquisition of a bank within the region. They also have the effect of excluding bank holding companies that are, or that are controlled by, foreign banks having their IBA home state within the region, because foreign banks, by definition, have a majority of their deposits outside the United States. These kinds of provisions, of course, also exclude U.S. controlled bank holding companies from outside the region.

Nonbanking Activities of Bank Holding Companies

Prior to the IBA, the Bank Holding Company Act of 1956 (BHCA) applied only to foreign entities having U.S. subsidiary banks. Such foreign entities were by definition bank holding companies and their direct and indirect U.S. activities were subject to the BHCA. The IBA established national treatment for other foreign banking organizations with U.S. agencies, branches, or commercial lending companies by generally subjecting their U.S. activities to the nonbanking provisions of the BHCA and thereby to the limitations that apply to domestic U.S. bank holding companies in their activities conducted through nonbank subsidiaries.[1]

The IBA subjected foreign banks that operate a branch, agency, or commercial lending company subsidiary in the United States or that control a bank in the United States, and any company of which such a foreign bank is a subsidiary, to the nonbanking provisions of the BHCA.

A bank holding company may not engage in any activity other than banking or activities that the Board finds are closely related to banking. These activities have been deemed by the Board to include consumer and commercial lending, credit card operations, trust business, certain types of data processing and management consulting, foreign exchange advisory services, acting as, among other things, a futures commission merchant on financial instruments, and operating thrift institutions. Foreign banks may participate in all these activities through subsidiaries. The Board has also found that certain securities activities, described further below, are closely related to banking and permissible for bank holding companies, including foreign banks subject to the BHCA.

Grandfathered Nonbanking Activities of Foreign Banking Organizations

In addition to grandfathered interstate banking operations, there are two additional significant exceptions to the general policy of national treatment that work in favor of foreign banks.

First, all nonbanking activities conducted by foreign banks before July 26, 1978, including securities activities, are grandfathered. The foreign bank may continue to engage in the nonbank activity despite the fact that a U.S. bank holding company may not engage in the same activity. The foreign bank may expand the number of locations at which it conducts any grandfathered nonbank activity and otherwise expand de novo; however, the foreign bank may not expand the nonbank activity through merger or the acquisition of a going concern.

The grandfathering provision is of particular benefit to those foreign banks that had operated securities affiliates in the United States before the passage of the IBA. Seventeen foreign banks had already established securities affiliates, which they were permitted to retain, but new establishment of securities subsidiaries by these foreign banks was limited to the same extent as for domestic holding companies.

The IBA also grandfathered the investments that these foreign banks had in securities companies, but prevented them from acquiring additional securities companies or commencing new securities activities. They are otherwise free to continue to conduct any securities activity, including underwriting or dealing, that was being conducted on the date grandfathered. The securities affiliate may expand through internal growth and establish new offices or subsidiaries to conduct the activities. Therefore, these foreign banks currently enjoy a significant competitive advantage over U.S. banks and bank holding companies and receive better than national treatment with respect to their U.S. securities operations.

The second exception allows foreign commercial and industrial affiliates of foreign banks to conduct commercial and industrial activities in the United States that are not permissible for U.S. bank holding companies. This exception is intended to prevent disruptions in foreign affiliations where a foreign bank controls commercial or industrial companies that do some business in the United States. This exception does not permit foreign banks to conduct financial activities in the United States that are not permitted to U.S. banks and bank holding companies.

Securities Activities of Banking Organizations in the United States

The Glass-Steagall Act, enacted in 1933, established a significant separation between commercial and investment banking in the United States. Under this law and Federal Reserve regulation, banks are generally prohibited from underwriting or dealing in securities of nongovernmental issuers. The IBA restricts the ability of a federal branch or agency of a foreign bank to underwrite or deal in securities by applying the restrictions applicable to national banks to such branches or agencies. State-licensed branches or agencies are similarly restricted by subjecting those branches and agencies to the prohibitions on underwriting or dealing in securities found in the Glass-Steagall Act as if they were member banks of the Federal Reserve System. Apart from these restrictions, U.S. branches, agencies and subsidiary banks of foreign banks have powers comparable to those of domestically owned institutions, i.e., powers accorded under the applicable banking laws as interpreted by the relevant federal and state banking authorities. Foreign-owned subsidiary banks are treated just like any other federally or state-chartered bank.

Although banks in the United States are generally prohibited from underwriting or dealing in securities of corporate issuers, subsidiaries of bank holding companies may engage in such activity to a limited degree, and banks may engage in many other securities activities. A foreign bank is in the same general position as a U.S. bank or bank holding company with respect to ability to conduct securities activities in the United States and is thus accorded national treatment.

National or state-chartered commercial banks, including their subsidiaries (collectively referred to hereafter as U.S. banks), and bank holding companies or subsidiaries of bank holding companies (collectively referred to hereafter as bank holding companies) located in the United States may engage in a similar (but not identical) range of securities and comparable activities. Both may underwrite and deal in obligations of the U.S. Government, general obligations of state and local governments, obligations of the Government of Canada and its political subdivisions as agreed under the U.S.-Canada Free Trade Agreement, and certain types of municipal revenue bonds (e.g., those issued to finance housing and university buildings and dormitories). National banks may securitize and sell their own assets. U.S. banks and bank holding companies may also privately place debt and equity securities.

U.S. banks and bank holding companies also may engage directly in brokerage or they may own discount brokers (i.e., securities brokerage firms which purchase and sell securities as agents for customers and do not provide investment advice).

In addition, U.S. banks or bank holding companies have engaged in a range of financial advisory activities, including offering investment advice to investment companies, institutions, and individuals. They have also engaged in certain collective investment activities: managing trust accounts, organizing common trust funds, collective employee benefit plans, and collective Individual Retirement Accounts (IRAs); and sponsoring, organizing and managing closed-end investment companies. Certain of the securities activities mentioned above may not be available both to banks and bank holding companies.

Underwriting and Dealing in Nongovernment Securities

One of the most significant trends in United States financial services is the movement toward greater participation in securities underwriting and dealing by affiliates of commercial banks through bank-holding company subsidiaries. The Glass-Steagall Act prohibits companies affiliated with a member bank of the Federal Reserve System from being "engaged principally" in underwriting or dealing in nongovernment securities. In 1987, the Federal Reserve Board determined that a nonbank affiliate of a bank would not be "engaged principally" in such activities if the affiliate's revenues from such activities did not exceed 5 percent of the company's total revenues. (The limit has subsequently been raised to 10 percent.) Initially, the Board authorized such affiliates to underwrite and deal in municipal revenue bonds, commercial paper, mortgage-related securities, and consumer receivables-related securities within this revenue limitation. This decision was litigated in the courts and upheld. The U.S. Supreme Court declined to review the case. As of June 1990, at least 10 foreign banks have been authorized to engage in this activity.

Section 20 Approvals

In January 1989, under the Federal Reserve Board's interpretation of Section 20 of the Glass-Steagall Act, the Board approved applications by five U.S. bank holding companies to underwrite and deal in all types of debt and equity securities subject to the revenue limitation and certain additional prudential restrictions or conditions. These conditions, or "firewalls", are designed to (i) insulate the U.S. bank from risks in the securities affiliate; (ii) limit the transfer of risk to the U.S. federal safety net; (iii) prevent conflicts of interest; and (iv) preserve competitive equality with securities companies not affiliated with banks.

The firewalls prohibit affiliated banks from providing credit to or for the benefit of the securities affiliate; prevent sharing of directors, officers or employees, or customer information; and require deduction of the securities affiliate's capital from the bank holding company's capital in computing capital requirements.

Before the Section 20 companies could actually begin to engage in the authorized debt and equity securities activities, they were required to undergo supervisory reviews of their operational and managerial infrastructures. The reviews associated with underwriting and dealing in debt securities were completed in June and July 1989, and the first review pertaining to underwriting and dealing in equity securities was completed in September 1990.

In 1990, the Board approved applications by five foreign banks to underwrite and deal in all types of securities subject to the same general framework of conditions and requirements applicable to domestic bank holding companies. All of a foreign bank's U.S. banking operations, whether conducted through a branch, agency, or subsidiary bank, are subject to the principal firewalls applicable to U.S. bank affiliates.

Certain conditions the Board applied to domestic bank holding companies were adjusted to account for the foreign status of the banks and to minimize any extraterritorial impact of the framework's requirements. These adjustments included that the foreign bank meet the risk-based capital adequacy standards of its home country supervisor consistent with internationally accepted standards under the Basle Accord; the foreign bank's U.S. banks, thrifts, branches and agencies would generally be subject to the same requirements as U.S.-owned banks, except that an interlock is permitted between a U.S. branch of a foreign bank and the foreign bank's U.S. securities subsidiary (interlocks are not permitted for U.S. banks); the foreign bank's non-U.S. operations would be treated in the same manner as those of a U.S. bank holding company; and the responsibility for compliance with the conditions of the Board's decisions is placed on the U.S. securities company, to avoid interference in the non-U.S. operations of the parent foreign bank.

The Board also required, as it did for U.S.-owned companies, that the applicants' U.S. securities subsidiaries undergo supervisory reviews of their compliance policies and procedures before the activities were commenced. Many foreign banks already engage in full securities activities in the major financial markets around the world and consider firewalls to be unnecessary. They argue that the firewalls do not enhance existing safeguards that ensure the safety and soundness of banks and that the firewalls impede efficient and integrated financial service.

Private Placements

U.S. banks also act as agent in the private placement of all types of securities. In November 1989, the Board extended this to bank holding companies (by approving applications from two U.S. bank holding companies). This activity, which is not considered underwriting because it is not offered on public markets, must be conducted within the limits of U.S. securities law and within certain prudential limits that generally prohibit an affiliated bank from purchasing for its own account or providing a credit enhancement for any security privately placed by a securities affiliate. The Board has since approved at least six foreign banks to engage in this activity.

In April 1990, the SEC adopted Rule 144A, which provides a safe harbor from registration under the Securities Act of 1933 for resales of privately placed securities to qualified institutional buyers. Banks, domestic or foreign, that own or manage on a discretionary basis at least $100 million of securities and have a net worth of $25 million can be qualified institutional buyers in that market.

Primary Dealers

The core participants in the United States Government securities market are 41 primary dealers. Some of the primary dealers are banks or bank subsidiaries, some are departments of general securities broker-dealers (including subsidiaries of bank holding companies) and others are firms specializing in government securities and other money market instruments.

Primary dealers maintain an active market through their willingness to buy and sell (make bids and offers on) a full range of Treasury issues at all times. These dealers are the most significant -- but not the only -- purchasers of new Treasury debt and provide investors with the liquidity that is a major characteristic of the most active capital market in the world.

Firms designated "primary" dealers by the Federal Reserve voluntarily report daily to the Federal Reserve Bank of New York (FRBNY) on their volume of trading and their positions (holdings) in government and government agency issues. They also provide periodic reports on financing and their financial condition.

The Federal Reserve System is a major participant in the government securities market. In conducting open market operations, the FRBNY buys and sells U.S. Government securities on behalf of the System. Open market operations are the major tool used by the central bank to influence the cost and availability of money and credit. While all dealers trading with the FRBNY in the System's open-market activities must be primary dealers, not all primary dealers necessarily trade with the FRBNY, although most usually do. To establish a trading relationship with the FRBNY, a dealer must be regarded as making sizable and continuous markets in the full range of government securities and must achieve somewhat higher trading volume than required for designation as a primary dealer.

The FRBNY has outlined the standards and procedures it uses to determine whether a firm should be added to the list of primary dealers. In general, primary dealers are expected to: 1) make markets in the full range of Treasury issues for a reasonably diverse group of customers; 2) participate meaningfully in Treasury auctions; 3) be committed to continue as a market-maker in these securities over the long term; 4) have management depth and experience and good internal controls; and 5) have sufficient capital to support their activities and prudently manage their risk exposure. Given the current number of active participants and trading volume in the market, primary dealers are expected at a minimum to have an average of one percent of the total customer volume of all current primary dealers. While there is no specified minimum level of capital -- which is evaluated in relation to risk -- the FRBNY has indicated it believes a significant market-maker would have difficulty functioning prudently with less than $50 million of capital.

In its relations with primary dealers, the FRBNY accords foreign-owned dealers essentially the same treatment as domestically owned dealers, subject to the constraints of the Primary Dealers Act of 1988. That Act requires the Federal Reserve to determine whether U.S. firms operating in the government debt markets of certain foreign countries have "the same competitive opportunities" as domestic companies operating in those markets. If a country does not offer "the same competitive opportunities" to U.S. firms, a person (including a company) from that country may not control a primary dealer in the United States. (The Federal Reserve "may not designate or permit the continuation of any prior designation" of a firm from that country as a primary dealer.) Pursuant to the Act, which took effect on August 23, 1989, the Federal Reserve conducted extensive studies of the government debt markets in the United Kingdom, Japan, Switzerland and Germany. It determined that U.S. firms are accorded "the same competitive opportunities" as domestic firms in the U.K., Japan and Switzerland, the only countries for which determinations were required to be made. Several firms were either exempt from the Act because of trade agreements with the United States or had been designated as primary dealers prior to July 31, 1987 and were grandfathered. As of October 18, 1990, 15 of the 41 primary dealers were owned by foreign firms from five countries.

Futures, Options and Commodities Activities

With some exceptions, both banks and bank holding companies are limited generally by their bank regulators to engaging in futures transactions in financial instruments. They may trade options and futures for proprietary purposes although both the OCC and the board have limited proprietary trading of options and futures outside of well-managed government securities dealer operations. In addition, they may act for customers in such trading if the underlying instrument or commodity is permissible for banks to hold or the permission of its regulator is obtained. Transactions in the United States involving all securities options and foreign currency options traded on a national securities exchange are governed by securities laws. Transactions in futures and commodity options, which include options on futures and certain commodities including foreign currencies conducted on domestic futures exchanges, are governed by the Commodity Exchange Act (CEA). Banks may generally purchase and sell (write) exchange-traded commodity options for their own accounts and for customers. With regard to off-exchange trading of commodity options, regulations under the CEA permit banks to purchase commodity options for proprietary purposes, but to sell such options only to a "commercial user" of the commodity underlying the option in question.[2]

Any bank or bank holding company acting in the futures or commodity options markets solely for proprietary purposes is deemed to be a trader under rules and regulations of the

Commodity Futures Trading Commission (CFTC) and thus is subject to all CFTC regulatory requirements applicable to traders, including large trader reporting of futures and options positions.[3] These requirements apply irrespective of the trader's location in the United States or abroad. Any bank or bank holding company acting in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading adviser (CTA), or commodity pool operator (CPO) must register in the appropriate capacity with the CFTC. (These activities are defined below. See National Treatment Under U.S. Commodities Law.) Both foreign and domestic banks are subject to the same regulations with respect to their futures and commodity-option activities; foreign-owned banks in the United States and foreign bank holding companies are treated the same as U.S. banks and bank holding companies. Banks and bank holding companies have performed brokerage (FCM or IB) and investment advisory (CTA) services and have acted as fiduciaries for pooled investment funds (CPO) in connection with a variety of futures and options contracts.

Under the Bank Holding Company Act and Regulation Y issued by the Federal Reserve Board, bank holding companies are expressly authorized to act, by means of a subsidiary, as FCMs and CTAs for a customer with respect to a variety of commodity futures and option contracts in financial instruments, including bullion, foreign exchange, government securities and certain money market instruments.[4] These types of activities are characterized as so closely related to banking as to be a proper "incident" thereto. On a case-by-case basis, bank holding companies may also seek to engage in conduct not specified in Regulation Y; the Board has approved among other things, transactions involving stock index and municipal bond futures as permissible activities for operating subsidiaries of bank holding companies.

National banks may trade for their proprietary accounts in financial futures contracts, which would include, for example, Government National Mortgage Association (GNMA) futures and Treasury bill futures. The OCC has determined that a bank's ability to engage in this type of futures transaction is essential to its ability to hedge risks associated with interest rates.

The OCC has determined on a case-by-case basis that activities for customers that can be undertaken by national banks include providing execution, clearance and investment advisory services for financial futures and options by means of an operating subsidiary. The OCC recently permitted an FCM-subsidiary of a bank to engage in brokerage services in connection with agricultural commodities and has also permitted a bank subsidiary to act as a sole general partner and CPO of a limited partnership trading foreign currency spot, forward, futures and option contracts.

The recent marketing of hybrid instruments that couple elements of futures contracts or commodity options with certain banking instruments, e.g., depository obligations, has raised issues concerning the treatment of such instruments by the CFTC under the CEA and CFTC regulations. To address these issues, the CFTC has issued a statutory interpretation stating that certain categories of instruments that meet certain criteria are excluded from regulation under the CEA. The CFTC has also adopted regulations that establish an exemption from CFTC regulations under the CEA for certain hybrid instruments that combine characteristics of commodity option contracts with debt, preferred equity or depository interests, and that meet certain criteria specified in the exemptive rule. In addition, CFTC has issued a policy statement that clarifies the treatment of certain swap transactions under the CEA and CFTC rules. Specifically, the CFTC's policy statement identified those swap transactions that if specified criteria are met, will not be regulated as futures or commodity option transactions under the CEA.[5]

Under the CEA, whether a person is required to register with the CFTC generally is a function of that person's contacts with U.S. markets and/or its customers resident in the United States. As elaborated upon below (see National Treatment Under U.S. Commodities Law), the CFTC has not required persons located outside the United States, who provide commodity-related brokerage and advisory services to non-U.S. persons regarding instruments traded on a U.S. futures exchange, to register with the CFTC.[6] Nor has the CFTC required non-U.S. persons who solely carry an intervening U.S. FCM's customer omnibus account for execution of transactions on foreign exchanges to register with the CFTC.

Foreign banks that are permitted to act directly in a brokerage capacity in their home jurisdictions, however, would not be automatically considered to be "located outside the United States" for purposes of relief from registration if such banks maintain branches in the United

States that act solely in a banking capacity. For example, the CFTC has exempted certain banks in Japan and in the United Kingdom from the registration requirements based on, among other things, representations and undertakings from the foreign banks that their U.S. banking branches will not engage in any activity subject to regulation under the CEA (except for proprietary purposes), and that they will provide the CFTC with access to the books and records of the U.S. bank branches to ensure compliance with such representations and undertakings.

Insurance Activities of Banking Organizations

Banks and bank holding companies are generally not permitted to sell and underwrite insurance except in limited circumstances. National banks are permitted to act as brokers to sell variable rate as well as fixed-rate annuities for insurance companies. National banks may act as insurance agents in towns with a population of less than 5,000 even though the principal office of the bank is located in a community with a population greater than 5,000. In connection with extensions of credit, the OCC has permitted national banks (1) to act as brokers to sell and also to underwrite title insurance as well as credit life, accident and health insurance, and (2) to act as brokers to sell collateral property insurance (vendors single interest insurance and vendors double interest insurance). Federally licensed branches or agencies of foreign banks may conduct these same activities. Bank holding companies are more restricted in their insurance activities. A bank holding company may underwrite and sell credit life, accident and health insurance related to extensions of credit by the bank holding company or any of its subsidiaries. Subsidiaries of foreign banks may engage in the same activity.

State law governs the operation of state-chartered banks and state licensed branches and agencies. Many states allow banks to act as insurance agents. In May 1990, Delaware enacted a statute that would allow a Delaware-chartered bank to underwrite and sell any type of insurance. The insurance activities are required to be conducted in a separate department of the bank, and insurance assets and liabilities must be kept separate from bank assets and liabilities. It is expected that the insurance industry will challenge this statute.

Reinsurance Letters of Credit

Under the insurance codes and regulations of some states, standby letters of credit issued by U.S. branches of foreign banks are not eligible to secure the obligations of foreign reinsurers because the issuing bank is not a member of the Federal Reserve System. Foreign banks have complained that foreign reinsurers in the major reinsurance markets of the world are forced to obtain letters of credit from U.S. banks, generally operating through their foreign branch offices, rather than through the U.S. offices of their foreign home-country banks.

The U.S. Treasury Department encouraged the National Association of Insurance Commissioners (NAIC) to adopt its model law on Credit for Reinsurance and to provide national treatment for foreign banks. The model law recognizes the acceptability of standby letters of credit issued by or confirmed by U.S. branch or agency offices of foreign banks meeting certain specified standards of financial standing. New York has adopted a similar rule to accommodate foreign banks. California and Illinois recently amended their laws to permit foreign banks that meet the NAIC standards to issue reinsurance letters of credit. Under the California law, effective January 1990, foreign banks must be "of financial standing that is satisfactory to the Commissioner." Thus, the two largest state banking markets now generally provide foreign banks with equality of competitive opportunity in the reinsurance market.

Foreign banks continue to complain that the revised standards discriminate to some extent against the operations of foreign banks because they impose much more stringent financial tests on foreign banks than on U.S. banks.

Federal Response to Foreign Bank Complaints

In addition to concerns about state insurance company law and procedure for acceptable reinsurance letters of credit, a recent study by the Institute of International Bankers discussed other concerns that policies applied to foreign banks or to their U.S. branches and agencies are discriminatory or unduly burdensome.[7] These concerns arise from U.S. immigration law; federal and state tax law; state securities law; federal and state laws governing investments by savings and loan associations; state law affecting entry of foreign bank operations; and the Federal

Reserve's rule regarding the electronic payments system, Fedwire. In May 1990, the Federal Reserve Board modified its policy on Fedwire regarding agencies and branches of foreign banks effective January 1991.

The Treasury Department has considered specific cases of discrimination, such as that involving reinsurance letters of credit, when brought to its attention. Treasury has actively encouraged the states and regulatory agencies to eliminate discrimination and denials of national treatment where they exist. Treasury has also intervened to urge against adoption at the state level of a reciprocity standard for bank entry. The Treasury Department does not, however, attempt to monitor or inventory state or federal regulation, as to do so would most likely be beyond its resources and generally inconsistent with a dual system of federal and state regulation. Treasury does urge and seek conformance with internationally agreed norms of national treatment for financial institutions as well as implementation of the policy of equality of competitive opportunity when it is clear that those standards have not been met.

NATIONAL TREATMENT UNDER U.S. SECURITIES LAWS

In the United States, securities and transactions involving securities are generally regulated under the federal securities laws, which are administered and enforced by the Securities and Exchange Commission (SEC). The federal securities laws are applicable to a broad variety of instruments defined as "securities," including generally notes, stocks, bonds, debentures, and investment contracts; puts, calls, straddles, options, and privileges on any "security"; and any instruments commonly known as "securities."

The federal securities laws in most cases provide national treatment for persons engaged in the securities business within the United States. In addition, foreign issuers generally are subject to substantially the same requirements as U.S. issuers. In fact, the SEC has adopted specialized registration and reporting forms to accommodate foreign issuers. Recent SEC initiatives have addressed issues raised by movements toward global trading of securities and the development of closer links between national securities markets.

Brokers and Dealers

Investment banking activities, such as syndicating, underwriting, and marketing offerings, and secondary market operations, such as brokerage and market making, are performed by broker-dealers. Also, there have been combinations by broker-dealers with insurance companies, with firms offering other financial services (e.g., commodities, credit cards and travelers' checks), and with some companies in unrelated areas, such as travel and real estate. In addition, broker-dealer firms compete with commercial banks in some activities, such as organizing money market mutual funds or selling bank certificates of deposit for fees. At the same time, commercial banks or their subsidiaries offer some securities-related services, notably in the areas of discount brokerage, investment advice, and self-directed individual retirement accounts.

The Securities Exchange Act of 1934 (Exchange Act) gives the SEC broad regulatory authority over U.S. securities markets and persons in the securities business. Pursuant to the Exchange Act, the SEC supervises the activities of broker-dealers, the national securities exchanges, and the over-the-counter market.

A broker-dealer (other than a U.S. bank) that uses the U.S. mails, or any means or instrumentality of interstate commerce in connection with its business, generally must register under the Exchange Act. The SEC's policy is one of equal market access in that the SEC seeks to apply the same requirements to all broker-dealers, whether U.S. or foreign-owned or U.S. or foreign-resident. These requirements include filing a registration form with the SEC, complying with record-keeping and record-maintenance requirements, and complying with capital and customer protection standards. The SEC requires a nonresident foreign broker-dealer, as a prerequisite to registration, to appoint the SEC as agent for service of process for securities-law-related claims arising out of the conduct of its business as a registered broker-dealer.

In 1989, the SEC adopted Rule 15a-6 under the Exchange Act to provide exemptions from broker-dealer registration requirements for foreign broker-dealers that engage from offshore in certain activities involving U.S. investors and securities markets. These activities include; (1) "non-direct" contacts by foreign broker-dealers with U.S. investors and markets, through execution of unsolicited securities transactions and provision of research to certain U.S. institutional investors; and (2) "direct" contacts, involving the execution of transactions through a registered broker-dealer intermediary with or for certain U.S. institutional investors, and without this intermediary with or for registered broker-dealers, banks acting in a broker or dealer capacity, certain international organizations, foreign persons temporarily present in the United States, U.S. citizens resident abroad, and foreign branches and agencies of U.S. persons.[8]

In a 1989 concept release, the SEC solicited comments on a conceptual approach to regulation of foreign broker-dealers that would recognize comparable foreign regulation of broker-dealers to facilitate international securities transactions, without compromising the essential protection afforded by U.S. broker-dealer regulation. The conceptual approach, if adopted, would exempt foreign-located broker-dealers from full U.S. broker-dealer regulation based on four elements: (1) the existence of comparable foreign regulation; (2) the existence of agreements between the SEC and foreign regulators that provide for cooperation and coordination in regulatory and enforcement matters; (3) compliance by exempted broker-dealers with specific U.S. regulatory requirements deemed necessary by the SEC for the protection of U.S. investors and markets; and (4) a limitation on the scope of the exemption to foreign broker-dealers operating outside the United States whose business is predominantly foreign, who do not have U.S. broker-dealer affiliates, and who limit their activities requiring U.S. broker-dealer registration to providing cross-border services to major U.S. institutional investors.[9]

Registered broker-dealers must join one or more securities self-regulatory organizations (SROs). In general, SROs are statutorily authorized, quasi-private bodies, such as the national securities exchanges and the National Association of Securities Dealers, Inc. (NASD), the only registered national securities association. An SRO is responsible for compliance by its members with rules of the SRO as well as with the federal securities laws, and is subject to the supervision of the SEC. The Securities Acts Amendments of 1975 specifically limit the ability of the national securities exchanges and the NASD to exclude registered broker-dealers from membership, ensuring that foreign ownership is not a ground for denial of membership. Foreign incorporation, or other organization, of the foreign-owned broker-dealer is not a bar to membership in the NASD and most regional exchanges, but it is on the New York and American Stock Exchanges. Thus, the rules of the two principal exchanges permit foreign-owned members but require those members to be organized in the United States.

Registered broker-dealers are not required to report to the SEC the extent to which they are owned by foreigners. That fact is itself an indication of the extent to which national treatment is accorded to foreign broker-dealers. However, foreign ownership of 10 percent or more in broker-dealers resident in the U.S. is required to be reported to the Commerce Department's Bureau of Economic Analysis. Commerce Department data on foreign investment in broker-dealers are not available separately, but are included in the "other finance" category in the direct investment statistics. The next chapter in the study includes data on this subject.

Since late 1987, brokers and dealers whose business is solely in U.S. government securities have been required to register and to meet standards established by the Secretary of the Treasury concerning financial capacity, protection of customer securities and balances, and record-keeping and auditing. The Government Securities Act of 1986 does not distinguish between foreign and domestic government securities brokers and dealers. Nonbank government securities brokers and dealers are required to join an SRO and register with the SEC. Bank government securities dealers, instead of registering with the SEC, are required to notify their appropriate federal regulatory agency of their status as government securities brokers or dealers. This requirement applies to domestic and foreign banks and to U.S. branches and agencies of foreign banks engaging in the government securities business.

Investment Advisers

Under the Investment Advisers Act of 1940 (IAA), foreign investment advisers that use the U.S. mails or any means or instrumentality of interstate commerce in connection with their business are required to register with the SEC, unless an exemption is available. An investment adviser is defined as one who, for compensation, "engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or . . . as part of a regular business, issues or promulgates analyses or reports concerning securities. . . ."

The following are excluded from the definition of investment adviser: U.S. banks and bank holding companies (but not banks located abroad); lawyers, accountants, engineers, or teachers whose investment advice is solely incidental to the practice of their professions; brokers or dealers whose investment advice is solely incidental to the conduct of their business as brokers or dealers and who receive no special compensation for such advice; publishers of any bona fide newspaper or financial publication of general and regular circulation; and persons giving advice only with respect to U.S. Government securities. In addition, certain types of investment advisers are exempted from the registration requirements of the IAA: any adviser whose clients are all in the state in which the adviser conducts his business and who does not advise with respect to securities listed, or having unlisted trading privileges, on a national securities exchange; any adviser whose only clients are insurance companies; and any adviser with fewer than 15 clients who neither holds himself out to the public as an investment adviser nor advises registered investment companies.

No particular qualifications are required for registration, and the SEC seeks to apply the same requirements to foreign and domestic investment advisers. Although foreign domicile may render a bank ineligible for the bank exclusion from the IAA, in other respects, the IAA generally establishes a national treatment standard. Registered advisers are subject to antifraud provisions (as are unregistered advisers), limitations on advisory compensation, and disclosure and record-keeping requirements. The SEC requires a foreign investment adviser, as a prerequisite to registration, to appoint the SEC as agent for service of process for securities-law-related claims arising out of the conduct of its business as a registered investment adviser.

Investment Companies

The Investment Company Act of 1940 (ICA) requires registration with the SEC of all non-exempt investment companies. Investment companies required to register under the Act are subject to statutory provisions that regulate, among others things: composition of management and management's accountability to shareholders; approval of investment advisory contracts; changes in fundamental investment policies; transactions between the investment company and affiliated persons; and the capital structure of the investment company.

Under section 7(d) of the ICA, a foreign investment company -- one not "organized or otherwise created under the laws of the United States or of a State" -- may not, in connection with a public offering, offer for sale, sell, or deliver its securities through the mails or interstate commerce unless the SEC by order finds that "it is both legally and practically feasible effectively to enforce the provisions of [the ICA] against such company." In effect, the ICA requires the SEC to find that investors in foreign investment companies have the same protections as investors in domestic investment companies. This standard is difficult to meet, particularly for funds organized in civil, rather than common, law countries. In 1954, the SEC adopted Rule 7d-1 to set forth minimum conditions and undertakings required for a Canadian company to obtain an order under section 7(d). All of the funds that have received exemptive orders under section 7(d), both Canadian and non-Canadian, have complied with the substantive conditions of Rule 7d-1. Currently, three Canadian companies and one South African company are registered with the SEC.

The SEC has suggested an alternative for foreign money managers, which is to organize an investment company in the United States that "mirrors," or invests in the same type of securities as, the foreign investment company, and to register the mirror fund to sell its shares in the United States.[10] A growing number of publicly offered U.S. investment companies invest in foreign securities. Many of these so-called international funds are thought to be mirror funds. The advisers or sub-advisers of international funds often are located abroad.

A foreign bank (and certain other foreign entities such as foreign insurance companies) may be considered an investment company under the ICA if it is sufficiently involved in holding or trading securities. Although banks operating under U.S. law are expressly excepted from the definition of investment company by Section 3(c) (3) of the ICA, foreign banks may not rely on that exception. In August 1990, the SEC adopted an interpretation of the ICA that treats U.S. branches and agencies of foreign banks as banks operating under U.S. law for purposes of selling their securities in the United States.

In 1987, the SEC adopted Rule 6c-9, which permits a foreign bank, and its finance subsidiaries, to offer or sell their debt securities or nonvoting preferred stock if the bank is engaged regularly in, and derives a substantial portion of its business from, extending commercial and other types of credit, and accepting demand and other types of deposit, that are customary in the bank's home country.[11] The rule conditions the offer or sale on the following: (1) the debt securities or nonvoting preferred stock is registered under the Securities Act of 1933, or is offered or sold pursuant to an exemption from such registration requirements; (2) any debt securities issued will be direct obligations of the issuer and any nonvoting preferred stock issued will be a direct interest in the issuer; and (3) the bank, and any non-U.S. finance subsidiary, has filed with the SEC a form appointing an agent located in the United States for service of process in actions arising out of the offer or sale of the securities. On August 15, 1990, the SEC proposed amendments to Rule 6c-9. The proposed amendments would expand the rule to include (1) equity securities of foreign banks and their finance subsidiaries, (2) all securities of foreign insurance companies and their finance subsidiaries, (3) all securities of foreign bank holding companies and foreign insurance holding companies, and (4) all securities of Canadian trust and loan companies, to facilitate their use of the proposed multijurisdictional disclosure system (discussed below).

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offerings of securities in the United States, and requires registration of securities prior to their offer or sale unless an exemption from registration is available.

Section 3(a)(2) of the Securities Act exempts from registration under that Act securities issued or guaranteed by certain domestic government entities. The exemption does not extend to securities issued or guaranteed by a foreign government. Public offerings of such securities must therefore be registered under the Securities Act. Schedule B of the Securities Act provides specialized disclosure requirements for such offerings.

Securities issued or guaranteed by a bank are not subject to the registration requirements of the Securities Act. This exemption applies only to securities issued or guaranteed by banks, as opposed to bank holding companies or nonbank affiliates of banks. "Bank" is a term defined by the Securities Act to include U.S. banks. The SEC has deemed U.S. branches and agencies of foreign banks to be included in the exemption, provided they are subject to state or federal regulation substantially equivalent to that applicable to U.S. banks doing business in the same jurisdiction.[12]

Under the Exchange Act, issuers whose securities are publicly traded in the United States are subject to, among other things, periodic reporting, proxy, and insider reporting provisions. In principle, public offering and periodic reporting requirements for foreign issuers are the same as SEC requirements for domestic issuers. Thus, the federal securities laws apply the concept of national treatment to foreign issuers. In practice, the SEC has attempted to adjust its disclosure requirements to accommodate foreign issuers because of differences among the countries in legal and accounting practices. Separate registration and reporting forms for foreign private issuers have been adopted under both the Securities Act and the Exchange Act. Form 20-F serves as both a registration statement and annual report form under the Exchange Act for foreign private issuers. Some of the accommodations made in that form include limiting management compensation disclosure to disclosure made on a group basis and requiring information on transactions with management only if such disclosure has already been made pursuant to applicable foreign laws. Annual reports must be filed, but periodic reports need be furnished only to the extent that they are either required to be made public by applicable foreign regulations or are distributed to security holders. The order of the SEC approving rules of the New York and American Stock Exchanges regarding interim reporting by non-U.S. companies indicated that at least semiannual financial information must be furnished.[13] Foreign issuers reporting on Form 20-F are not subject to the U.S. proxy solicitation regulations or those pertaining to insider reporting.

Financial statements for foreign issuers are not required to be prepared in accordance with United States generally accepted accounting principles (GAAP), established by the Financial Accounting Standards Board, or the SEC's regulation S-X, so long as reconciliation of significant variations from those standards is provided. There are two types of reconciliation. Item 17 of Form 20-F requires quantification of the material differences in net income and significant balance sheet items. Item 18 requires a full reconciliation, including all other disclosures and supplemental data required by GAAP and Regulation S-X, including full industry segment and geographic data. For most new issues, the Item 18 reconciliations would be required.

Form 20-F is the cornerstone of the separate integrated disclosure system for foreign issuers for public offerings under the Securities Act. The system presently consists of Forms F-1, F-2, F-3, and F-4. Forms F-2, F-3, and F-4, which are comparable to Forms S-2, S-3, and S-4 for domestic issuers, allow a foreign issuer to abbreviate the disclosure presented within the prospectus through incorporation by reference of the business and financial information found in Form 20-F. Form F-6 is used to register American depository shares represented by American depository receipts which are issued against the deposit of the underlying securities of foreign issuers.

The SEC has developed a proposal for multijurisdictional disclosure relating to specified securities and transactions. In February 1985, the SEC sought comments on methods to accommodate multinational offerings and to harmonize disclosure and distribution practices for foreign private issuers, in particular from Canada and the United Kingdom. Two methods were offered for comment: a reciprocal approach among nations, where a prospectus accepted in an issuer's domicile would be accepted in each of the countries where the securities are offered; and the development of a common prospectus to be filed in all participating jurisdictions.[14]

In July 1989, the SEC proposed a multijurisdictional disclosure system between the United States and Canada.[15] A parallel proposal was issued by Canadian regulators.[16] This system is intended as a prototype to be used to develop similar systems with other foreign jurisdictions.

The proposed system with Canada is a hybrid between the reciprocal approach and the common prospectus approach. The proposed system is intended to facilitate multijurisdictional and cross-border offerings of securities into the United States by specified Canadian issuers, and by specified U.S. issuers into Canada. With respect to cross-border offerings extended into the United States, the proposed system would permit eligible Canadian issuers to register securities in the United States by filing with the Commission and disseminating to U.S. holders disclosure documents prepared in accordance with Canadian law, including documents in connection with specified types of rights offerings. The system also would allow bidders in issuer and third party cash tender and exchange offers to comply with U.S. tender offer requirements using Canadian disclosure documents, where a limited proportion of the target securities is held in the United States. The system therefore would encourage Canadian issuers to extend rights and exchange offers to their U.S. security holders in cases where such holders might otherwise be excluded. The multijurisdictional disclosure system likewise would cover continuous reporting obligations in specified cases. As proposed, reconciliation of the financial statements to U.S. GAAP would not be required for offerings of investment grade debt by certain issuers, or for rights and exchange offerings. Reconciliation would be required for other equity offerings.

In June 1990, the SEC issued a release soliciting public comment on a conceptual approach designed to encourage foreign bidders to extend multinational tender and exchange offers to the U.S. holders of securities on the basis of foreign disclosure, procedural, and accounting requirements, where U.S. investors own a small percentage of the securities subject to such an offer.[17] The Release sought comment on the appropriate means to define that class of transactions in which U.S. holders are likely to be excluded from the offer if the offerer is required to comply with U.S. securities regulation.

In April 1990, the SEC adopted Regulation S, to clarify the extraterritorial application of the registration provisions of the Securities Act.[18] The Regulation consists of a general statement of applicability of the registration provisions and two safe harbors from registration. The general statement provides that the registration provisions do not apply to offers or sales of securities that occur outside the United States. For a transaction to qualify under the general statement, both the sale and the offer relating to the sale must be made outside the United States. One safe harbor applies to offers and sales by issuers, securities professionals involved in the distribution process pursuant to contract, their respective affiliates, and persons acting on behalf of any of the foregoing. The other safe harbor applies to resales by persons other than the issuer, securities professionals involved in the distribution process pursuant to contract, their respective affiliates (except certain officers and directors), and persons acting on behalf of any of the foregoing.

In April 1990, the SEC also adopted Rule 144A, which provides a nonexclusive safe harbor exemption from the registration requirements of the Securities Act for resales of restricted securities to "qualified institutional buyers."[19] Qualified institutional buyers must in the aggregate own and invest on a discretionary basis at least $100 million of securities ($10 million in the case of registered broker-dealers). Banks and savings and loan institutions, whether foreign or domestic, are subject to a further requirement of $25 million in net worth to be "qualified institutional buyers." The Rule may have significant implications for offerings by foreign issuers. In particular, as the proposing Release stated, foreign issuers who previously may have foregone raising capital in the United States due to cost and liability concerns may find financings in this country a more viable option as a result of Rule 144A and Regulation S.[20] The SEC has also approved a proposed rule change by the NASD implementing the PORTAL trading system, a new screen-based marketplace for secondary trading of unregistered securities pursuant to Rule 144A.[21]

In 1987, the rules of the New York Stock Exchange and the American Stock Exchange were amended in order to overcome the reluctance of foreign companies to list securities for trading on those exchanges. The rule changes permitted the exchanges to waive or modify certain of their listing standards for foreign companies when it can be shown that a foreign company's interim earnings reporting or corporate governance practices are based on the laws, customs, or practices of its home country.[22] In 1989, the New York Stock Exchange rules were further amended to permit such waiver or modification when the foreign company's practices are not prohibited by the laws of its home country (rather than when such practices are based on the laws or practices of its home country).[23] To provide an incentive for foreign-based companies to list their shares on the American stock Exchange, the rules of the American Stock Exchange were amended in 1989 to provide that the initial listing charge applicable to all non-U.S. domiciled companies traded on a foreign exchange would be discounted 50 percent from the existing fee structure applicable to domestic companies, subject to a maximum charge of $30,000.[24]

State Regulation of Securities Activities

The regulatory system for securities transactions in the United States is a comprehensive scheme administered by three groups: federal authorities, primarily the SEC; the SROs; and the individual states.

All of the states have enacted statutes,[25] popularly referred to as Blue Sky laws, primarily to prevent fraud in securities transactions.[26] Such laws generally require that securities offered or sold within a state be either registered in the state or exempt from registration. The Blue Sky laws also generally require that broker-dealers, investment advisers, and other persons in the securities business who operate in a state register with the state. Finally, Blue Sky laws generally contain antifraud provisions.

State regulation is in many respects similar to federal regulation, although a number of states go beyond the disclosure-oriented federal regulation of securities offerings and impose substantive requirements -- so-called "merit" regulation. Securities offerings must comply not only with federal law but also with the laws of each state where the security is offered. To minimize conflicting requirements, the National Conference of Commissioners on Uniform State Laws has promulgated the Uniform Securities Act (1956), revised as the Uniform Securities Act (1985). More than 30 states have adopted or substantially adopted the Uniform Securities Act.[27]

The question of whether state laws provide national treatment would have to be considered on a state-by-state basis.

NATIONAL TREATMENT UNDER U.S. COMMODITIES LAW

The Commodity Exchange Act (CEA) and regulations thereunder, in general, regulate all transactions involving futures and commodity options, which are options on futures and commodities, including options on foreign currency, but excluding all options on securities and foreign currency options traded on a national securities exchange regulated by the SEC. Under the CEA, the Commodity Futures Trading Commission (CFTC) regulates transactions conducted on domestic U.S. futures exchanges (contract markets in futures and options), of which there are currently 14. It also regulates futures and option transactions conducted for or on behalf of U.S. customers on both domestic and foreign markets. Section 2(a)(1) of the CEA is an exclusive jurisdiction clause, which states that the CFTC's jurisdiction over futures is deemed to supersede the jurisdiction of any other state or federal regulator and was intended to preempt the field insofar as futures regulation is concerned.[28]

In general, a financial intermediary engaged in transactions involving futures and option contracts regulated by the CFTC will be deemed to be subject to CFTC jurisdiction if it is legally domiciled in the United States, is physically present in the United States, has consented to jurisdiction or is considered to be conducting business in the United States. A financial intermediary considered to be conducting business in the United States need not be physically present in the United States. No distinction is made between solicited and unsolicited business.

Under the CEA, a foreign firm considered to be doing business in the United States is treated no less advantageously than a domestic firm.

Transactions on U.S. Markets

The CEA requires that all futures and certain option contracts traded in the United States must be effected on boards of trade that have been designated by the CFTC as contract markets. Moreover, the CFTC must approve each contract for trading on a particular contract market. Essentially, the domestic regulatory program contemplated by the CEA focuses on both market and customer protection. The regulations applicable to market protection generally address prevention of market manipulations and other price distortions. In the area of customer protection, the CEA and the regulations establish a comprehensive regulatory structure applicable to all regulated persons to prevent fraud and other wrongful conduct involving contracts for sale of futures and commodity options. This regulatory regime includes:

(1) Registration requirements intended to ensure the "fitness" of all persons who deal with customers or customer funds. By means of registration, the CFTC can identify and monitor the identification and qualification of these persons. The CEA describes the following categories of registrants:

- - A futures commission merchant (FMC) is defined as any person who solicits or accepts orders to buy or sell futures or option contracts, and who, in connection with an order, accepts any money or other property (or extends credit) to margin, guarantee or secure the contracts resulting from the order.

- - An introducing broker (IB) is any person who solicits or accepts orders to buy or sell futures or option contracts, but who does not accept any money or property (or extend credit) to margin, guarantee or secure the contracts.

- - A commodity trading advisor (CTA) is any person who, for compensation or profit, is engaged in business of providing commodity interest advisory services to others. The CEA specifically excludes from the definition of the term "commodity trading advisor" certain persons, including banks and news reporters, publishers and editors, who provide commodity advice that is "solely incidental" to the conduct of their business or profession.

- - A commodity pool operator (CPO) is any person who solicits funds from others for the purpose of pooling the funds for use in investing in commodity interests. Certain "otherwise regulated" persons and entities such as a bank, an insurance company or an investment company may be excluded from the term "commodity pool operator" with respect to their operation of "qualifying entities".[29]

- - An associated person (AP) is any person who is associated with the above categories of registrants who solicits or accepts customer orders or who supervises any person engaged in such activities.

(2) Minimum financial requirements for financial intermediaries that handle customer funds. These requirements address the financial integrity of the markets and persons transacting business on such markets. These requirements ensure that firms have sufficient funds to operate the business, that they

have some financial stake in their business and that, in the event of customer default, there will exist a cushion so that other customer funds will not be adversely affected.

(3) The strict segregation of customer funds from the funds of the financial intermediary that carries the customer account. A primary purpose of this requirement is to prevent the use of customer funds for purposes other than those specified by the customer and to provide protections to such funds from creditors of the carrying firm in the event of its default.

(4) A comprehensive sales practice program to prevent fraudulent and misleading sales practices in the marketing and handling of customer accounts.

(5) Compliance activities undertaken by the CFTC and the self-regulatory organizations (SROs) subject to its jurisdictions. The CFTC oversees and supervises the exchanges and National Futures Association (NFA) and imposes specific regulatory responsibilities on these SROs. These SROs in turn are required by statute and CFTC regulations to maintain extensive affirmative programs to assure the integrity of the markets and the participants they supervise. The SROs are subject to CFTC enforcement action for failure to comply with CFTC requirements.

(6) Record-keeping and reporting requirements. These are intended to assist in determining whether a registrant is acting in accordance with the provisions of the CEA and the rules, regulations and orders thereunder.[30]

Any person, whether domestic or foreign, who conducts business on a domestic futures market for a U.S. customer is subject to compliance with the full panoply of customer protections described above. However, when a person conducts business on a domestic market for a foreign customer, the determination as to whether that person is subject to CFTC regulation generally is a function of where that person is deemed to be located. For example, if the person conducting business is deemed to be located within the United States, such person will be required to register and otherwise comply with all of the CFTCs regulatory requirements applicable to registrants. If the person is located outside of the United States and is acting on U.S. markets in the capacity of, for example, an FCM with respect to foreign customers, however, that person may be subject to reporting requirements as a "foreign broker." "Foreign brokers" generally are defined as persons located outside of the United States that carry an account in futures or options for or on behalf of non-U.S. persons on U.S. markets through a carrying FCM. The CFTC staff has not required foreign brokers to register with the CFTC as FCMs; however, they remain subject to, among other things, the above referenced reporting requirements. The Commission similarly has stated that a foreign broker acting in the capacity of an introducing broker would generally not need to register as an introducing broker.[31]

The Commission's staff has taken a similar position with respect to persons located outside the U.S. who act in the capacity of a CPO or CTA.[32] Specifically, the CFTC's staff has stated that it would not recommend enforcement action against such persons for failure to be registered in the appropriate capacity provided such persons, among other things, confine their activities subject to regulation to an area outside of the United States and to clients who are neither U.S. residents nor U.S. citizens.

With respect to FCMs and IBs, most foreign firms that desire to engage in such activities choose to do so by means of a U.S.-based subsidiary or affiliate which, among other things, facilitates U.S. client contact. In addition, the CFTC's staff has indicated that an offshore applicant's failure either to maintain an office in the U.S. or to demonstrate that it has procedures to ensure CFTC and NFA access to its books and records may constitute grounds upon which registration may be denied.[33]

Transactions on Non-U.S. Markets

Prior to 1987, the sale of foreign futures to U.S. customers was essentially unregulated. Thus, firms in the U.S. and overseas could offer and sell these products to U.S. customers subject only to a general antifraud provision. The offer or sale of foreign options, with minor exceptions, had been banned since 1978. In 1987, the Commission promulgated a comprehensive set of regulations, the Part 30 rules, which govern the offer or sale of any foreign futures or options contract to a person resident in the United States. Therefore, among other things, the Part

30 rules provide a mechanism by which the ban on the offer or sale of foreign options may be lifted on the market-by-market and product-by-product basis. These rules apply to any person, whether a U.S. or non-U.S. resident, who engages in the above-mentioned activities with respect to a customer resident in the United States. The rules generally parallel the CEA's registration requirements for persons who act in the capacity of an FCM, IB, CTA or CPO. In effect, these rules extend existing customer protection regulation of domestic products offered in the United States to foreign futures and option products with respect to registration, sales practices (including disclosure), capital adequacy, protection of customer funds, compliance and record-keeping and reporting requirements.

There are two areas in which the CFTC's Part 30 rules depart from the regulatory regime applicable to domestic transactions. First, persons who act in the capacity of an LB, CPO, or CTA from a location outside the U.S. may be exempted from the CFTC's registration requirements provided that all of their U.S. customer accounts are carried by or through a U.S. FCM on a fully disclosed basis.[34] Such persons must otherwise comply with certain other requirements of the CFTC's regulations, e.g., the risk disclosure requirement of CFTC rule 30.6. Such persons also must enter into an agreement, filed with NFA, with an appropriate agent for the purpose of receiving communications from the CFTC, the Department of Justice and customers who do business with such persons and provide to the CFTC and Department of Justice access to their books and records within 72 hours of the request.

The second area in which the CFTC's regulatory regime for foreign transactions differs from that applicable to domestic transactions relates to persons acting in the capacity of an FCM. Specifically, such persons may apply for an exemption from the FCM registration requirement by virtue of the "comparability" of the regulations in effect in the jurisdiction in which such persons are located.

Comparability

Under the comparability provisions of the CFTC's Part 30 rules, persons located outside the United States, who solicit or accept orders and related funds from U.S. customers for foreign futures or options transactions, and who are subject to a comparable regulatory scheme in the jurisdiction in which they are situated, may apply for an exemption for the application of certain of the Part 30 rules applicable to such transactions. To date, the comparability petitions have been filed by foreign regulators or SROs on behalf of members and/or the firms which they regulate. Substitutions of the regulatory system of another jurisdiction for that imposed in the United States is an effort to avoid subjecting a foreign person to duplicative regulatory burdens without having regulatory gaps, by ensuring that the foreign jurisdiction's regulations provide protections to customers that are comparable to those in effect in the United States.

Specifically given the increasing internationalization of futures markets and the CFTC's desire to facilitate cross-border transactions, this "comparability" approach:

(1) is intended to assure that a U.S. customer receives similar protection with regard to the offer and sale of commodity futures and option products regardless of the market on which the product is traded;

(2) permits a firm based in a jurisdiction which has a comparable regulatory program and which monitors its firms for compliance with such requirements to comply, for the most part, with requirements imposed by its jurisdiction of domicile (thus acknowledging that the home jurisdiction of the firm is in the best position to monitor the firm for compliance); and

(3) provides flexibility in that it permits the CFTC to address both regulatory duplication and gaps. The comparability approach is not intended to reach the design of foreign products, or the trading, clearing, margining, or settlement rules of foreign markets.[35]

The CFTC's comparability program requires a two-tiered analysis. First, the CFTC reviews the rules and regulations of the applicable foreign regulator or SRO and will grant exemptive relief based upon an assessment that the regulations serve as an adequate substitute for compliance with U.S. rules and regulations. The minimum elements of a comparable regulatory program include: (a) registration, authorization or other form of licensing, fitness review or qualification of persons through whom customer orders are solicited and accepted; (b) minimum financial requirements for those persons who accept customer funds; (c) protection of customer funds from misapplication; (d) record-keeping and reporting requirements; (e) minimum sales practice standards, including disclosure of the risks of futures and option transactions, in particular the risk of transactions undertaken outside the jurisdiction of domestic law; and (f) compliance mechanisms.

The CFTC has broad discretion to determine that the purposes of any program element generally are met, notwithstanding the fact that the offshore program does not contain an element identical to that of the CFTC's regulatory program. In considering each petition the CFTC's staff has consulted extensively with foreign regulators and SROs in assessing the comparability of the foreign regulatory regime.

Second, as a condition of granting comparability relief to a specific firm, the CFTC requires that each firm requesting exemptive relief must be sponsored by its regulator or SRO and must provide certain consents and representations. These consents and representations include, among other things: consent to jurisdiction in the United States by filing an appointment of an agent for service of process; consent to provide immediate access to its books and records (which may be effected through a foreign regulator); consent to participate in an arbitration program implemented by the NFA for nonmember firms in connection with customer disputes involving foreign futures and options; consent that all futures or options transactions will be made on or subject to the rules of an exchange located outside the United States; representation that no principal of the firm would be disqualified from doing business under the CEA; and disclosure of the identity of any affiliate or subsidiary that is engaged in a related business.

The "comparability" exemption, however, does not exempt any person from other obligations under the CEA and regulations thereunder, including the antifraud or risk disclosure obligations contained in the foreign futures and option rules.

To date, the CFTC has approved the petitions submitted by exchanges, SROs and governmental entities in five jurisdictions: Australia (Sydney Futures Exchange), Singapore (Singapore International Monetary Exchange), Canada (Montreal Exchange and the Toronto Futures Exchange), France (the Commission des Operations de Bourse) and the United Kingdom (Securities and Investments Board, Association of Futures Brokers and Dealers, The Securities Association and Investment Management Regulatory Organization). To date, these SROs and governmental entities, in conjunction with the CFTC, in turn have designated approximately 100 firms as eligible for comparability relief.

Electronic Trading and Internationalization of Markets

With the advent of international computer linkages, novel questions have arisen with respect to the CFTC's jurisdiction. For example, through the Globex computerized trading system of the Chicago Mercantile Exchange, approved by the CFTC on February 2, 1989, it may be possible for a foreign exchange to "list" its products on the Globex system.

The CFTC staff has expressed its opinion that the mere presence of Globex terminals in the U.S. should not cause the CFTC to deem any foreign exchange for which products are listed through that system to be a "domestic" exchange for which contract designation and U.S. regulation are required. However, the staff also expressed concern that the relationship between the foreign exchanges and U.S. customers may raise regulatory concerns which the CFTC might not consider internal exchange affairs. Consequently, the staff has stated its opinion that the CFTC may review any proposal to trade contracts of a foreign exchange through Globex in light of the CFTC's obligations under the CEA to maintain the integrity of the U.S. markets and to provide for the protection of U.S. customers. For example, the Commission may review such proposals to determine whether access to information necessary to meet its own responsibilities under the CEA would be adequate.

NATIONAL TREATMENT IN THE U.S. INSURANCE INDUSTRY

The business of insurance in the United States is divided into two fundamental categories: (1) life and health insurance and (2) property and casualty insurance. During 1989, more than 6,000 insurance companies were based in the United States and operating under the supervision of regulatory authorities in the various states. Some of these companies sell all lines of insurance but most specialize. Some 3,800 of those companies sell some form of property and casualty insurance and related lines, including inland marine coverages, accident and health insurance, and surety and fidelity bonds. The remaining companies primarily write life and accident and health insurance.

The primary responsibility for regulation of the U.S. insurance sector rests with the states and not with the Federal Government. Congress formally conveyed this authority to the states in 1945 through the McCarran-Ferguson Act. Section 2(a) of the Act provides:

> The business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business.

The Act further specifies the business of insurance to be exempt from federal antitrust laws, except in discernible instances of boycott, coercion, or intimidation. Such instances have been infrequent since McCarran-Ferguson was passed, and, in effect insurance regulation remains primarily the domain of the individual states.

The states administer insurance regulations through state insurance departments. Each state has been allowed to tailor its insurance regulations according to its interests, although much uniformity of action is achieved through the efforts of the National Association of Insurance Commissioners (NAIC).

The U.S. insurance regulatory system, at its most fundamental level, is designed to protect insurance buyers and third parties. This goal is accomplished through laws and regulations designed to prevent or minimize the adverse impact on consumers of insurer insolvencies and to prevent unfair and deceptive marketing practices by insurers and their intermediaries.

To minimize insurer insolvencies, states have developed comprehensive insurance laws and regulations governing the financial operations of licensed insurers. These laws and regulations include minimum capital and surplus requirements, limitations on the size or risk retained, investment limitations, reserve requirements, and restrictions on the payment of dividends.

Insurance can be written either by licensed ("admitted") insurers in an individual state, or written "cross border," i.e., across state or national lines, by unlicensed ("nonadmitted") insurers (also referred to as surplus lines insurers). Many nonadmitted insurers are alien firms or U.S. branches of non-U.S. firms. Insurance written on a nonadmitted basis is not protected by the state guaranty funds. To protect their citizens who purchase such insurance, states have set up certain financial and managerial standards that nonadmitted insurers must meet. States enforce these standards through specially licensed agents and brokers through which such insurance must be placed.

States have promulgated regulations governing how insurers operate in the marketplace. These regulations are monitored by regulatory agencies through the handling of consumer complaints and periodic market conduct investigations. Insurers that violate these regulations may be subject to fines and other penalties.

A further responsibility of the insurance regulatory system is to ensure the availability of those types of insurance closely associated with social policy objectives. Thus, the states and the U.S. private insurance sector have established so-called residual market mechanisms for these necessary coverages when there is little or no availability for such coverage in the marketplace. Most states have established such mechanisms in order to make available automobile and selected property coverages to those unable to obtain them in the normal commercial market. A few states have also established state-run workers' compensation funds either as the exclusive provider of such coverage or as the insurer of last resort.

Each state insurance department is directed by a chief administrator typically entitled the insurance commissioner; in some states the regulator is elected and in other states he or she is appointed by the state's governor. All chief administrators belong to the NAIC. The NAIC has no formal legislative authority, but drafts model insurance bills and regulations. The models are intended to promote uniformity among state insurance regulations and hence facilitate the ability of insurers to do business across state lines. Many state statutes make reference to the NAIC in areas such as valuation of securities, accounting and reporting practices, examination procedures and approval of alien surplus lines companies.

The McCarran-Ferguson Act does not prevent Congress from legislating in the field of insurance but only requires that the intention to do so be clearly stated in the law. Indeed, the Federal Government is already involved in regulating the insurance industry in several important respects. Apart from operating government-administered insurance programs like crop insurance, insurance of deposits in banks and savings and loan associations, flood insurance, export credit insurance, political risk insurance, crime reinsurance, and insurance of damages caused by nuclear accidents and oil pollution, the Federal Government also exercises control over significant aspects of the insurance business through its legislative and administrative activities in areas like taxation, securities regulation, health care for the aged and poor, regulation of employee pension and welfare plans, risk retention groups and financial responsibility requirements in environmental protection laws. The enforcement of antitrust laws by the Department of Justice and the Federal Trade Commission has a substantial effect on the industry as well.

Treatment of Non-U.S. Insurers

As a general rule, non-U.S. insurers that seek to enter into and operate in the United States enjoy national treatment with equality of competitive opportunity. Since there is full freedom of establishment, non-U.S. insurers may choose to form or purchase a separate subsidiary, as can any U.S. insurer, or, alternatively, operate as a U.S. branch. Once established, non-U.S. insurers in general face no operating restrictions that are different from those faced by U.S. insurers in areas such as product approval, requests for increased working capital or regulations on investment.

In U.S. insurance terminology, a foreign insurer is a U.S. insurer incorporated in a state other than the one in which it is doing business. An alien insurer is an insurer incorporated in a country other than the United States.

Alien insurers operating as U.S. branches must furnish proof they are lawfully organized and licensed in their home jurisdiction and, like U.S. insurers, they are admitted in a number of states only if they have operated successfully elsewhere for a certain number of years.

To assure the ability of both foreign and alien insurers to satisfy their obligations, most states place great weight on the placement of deposits, which must be specifically secured by trust agreements. The amount of the trust account that is required varies: several states require trust accounts equal to the capital and surplus mandated for domestic companies, others require an amount to correspond to the insurer's liabilities.

These two requirements are based on different considerations. Whereas capital and surplus requirements relate to the overall financial health of the company, deposit requirements are designed to ensure that liquid assets will be readily available in order to satisfy the claims of residents of the state in the event of a default.

There are only two potentially significant exceptions to the general U.S. policy of national treatment in the insurance sector: the restriction on licensing of government-owned applicants and the methodology by which underwriting limits for alien insurers are calculated.

1. Restrictions on government ownership. Three states (North Carolina, North Dakota and Tennessee) prohibit the admittance or the issuance of a license to companies owned or controlled by foreign governments, and an additional 21 states prohibit the licensing of any publicly owned or controlled entity, whether of foreign or U.S. origin.

One concern is to prevent unfairly subsidized competition rather than to discriminate against non-U.S. providers. Other concerns include: location of assets, quality of regulation, and the susceptibility of contract enforceability if diplomatic problems arise. Nevertheless, for some countries with strong public financial sectors (notably France), the effects of this provision can be significant. It should further be stated, however, that, even if this provision were lifted, the general reluctance of publicly owned entities to meet U.S. financial reporting requirements would remain a serious obstacle to increased business in the United States.

2. Calculation of underwriting limits. Most states restrict the underwriting capacity of their insurers on any one risk to a maximum of 10 percent of the company's surplus net of reinsurance claims. For alien insurers with U.S. branches, however, the calculation of this surplus is usually based on the net assets retained in the United States in U.S. investments alone, thus potentially imposing lower underwriting limits on alien insurers than on their U.S. competitors.

The thinking behind this restriction lies in the realization that it can be difficult to achieve attachment of assets located outside the United States. Therefore, the assets do not present adequate security to meet the legitimate prudential concerns of the state regulators. Even the information on the level of an alien insurer's global surplus is often difficult or impossible to obtain.

Beyond these two exceptions, it has further been argued by some non-U.S. insurers that the very system of state regulation described above constitutes a significant market access barrier. Indeed, the administrative costs of meeting 54 separate sets of criteria (the 50 States, the District of Columbia, Puerto Rico, U.S. Virgin Islands and Guam) to do business in the United States are difficult to estimate, especially for an insurer with limited experience in the requirements of the American market.

It is also true, however, that the state regulatory system does not inherently discriminate against non-U.S. insurers and is therefore not at odds with the principle of equality of competitive opportunity. Alien insurers are generally no worse off than foreign insurers, i.e., a company from New Jersey must face the same hurdles in order to establish a branch in New York as must a company from Japan.

A number of other minor points have been examined for their effects on national treatment based on equality of competitive opportunity, but none of them evidence a significant effect on the ability of non-U.S. insurers to function effectively in the U.S. market. These include requirements in some states for higher deposits for foreign and alien firms, for foreign and alien firms to pay higher premium taxes than domestic firms, for U.S. citizenship or residency for company incorporators or directors, for local office and record retention and for annual renewal of licenses for alien insurers.

The Future of Equality of Competitive Opportunity in Insurance

The dynamic financial markets and regulatory system of the United States and growing global pressures could have an impact on the current situation regarding equality of competitive opportunity for non-U.S. insurers in two ways: a general "strengthening" of solvency requirements for insurers, including special attention to alien insurers; offset by continuing movement towards more regulatory uniformity or harmonization among the states.

Evidence of a more stringent attitude lies in a recent Congressional report on insurance company insolvencies.[36] This document questioned, among other things, current regulatory practices toward alien insurers, especially nonadmitted "offshore" reinsurers. The report adheres to the idea that all insurers should and must be able to meet specific regulatory requirements if they want to continue to do business with policyholders in the United States. These requirements include strong capitalization and sufficient assets in the United States to pay claims. The report disputed the idea that higher solvency standards for all insurers would reduce market capacity, stressing that "a well run market will reduce financial risks and create equal opportunity" among the legitimate insurers in the market. If these higher solvency standards are not placed on alien insurers, especially those who are subject to insufficient regulation in their home market, unpaid claims and guarantee fund assessments could drain domestic financial resources.

Even prior to the Congressional report, the NAIC had begun addressing solvency concerns by pressing for more state coordination and for increased discipline of states that are lax in solvency standards and enforcement. The NAIC has placed solvency policing as one of its priority concerns. Suggestions to alleviate the problem include strengthening financial regulatory standards, improving examination processes, enhancing the national regulatory information reporting system, and reviewing the adequacy of capital and reserve requirements. As more alien insurers enter the United States, state regulators will need to give appropriate attention to solvency concerns as they apply to alien insurers.

The possibility of the Federal Government playing a larger role in insurance regulation has general implications for the treatment of alien insurers. Certainly, just like the states, federal licensing and/or federal solvency requirements would need to address the differences between domestic and alien insurers, particularly nonadmitted alien insurers. Federal regulation would have to consider the insurer's ability and willingness to pay claims. For alien insurers, there is the problem of the location of assets outside the United States in foreign jurisdictions and legal access to those assets in the event of unfulfilled claims or insolvency.

Even without an increased federal regulatory role, the states, as has been indicated, are moving on their own towards action to create a more uniform "national" insurance market. For example, a concept currently under debate in the industry and among the states would allow domestic, foreign and alien insurers licensed in a state, that has recognized standards for licensing and monitoring insurers, to automatically do business in other states. This concept, although controversial, is somewhat similar to the changes being considered and implemented for the 12 countries of the European Community. In addition, achievement of a services agreement in the Uruguay Round negotiations of the General Agreement on Tariffs and Trade may lead states to remove or reduce regulatory barriers to non-U.S. insurers, again bringing more regulatory consistency among the states.

Notes

[1] The IBA made the BHCA less restrictive in its application to foreign banking organizations than to U.S. bank holding companies with respect to their commercial and industrial activities but not with respect to their securities activities. In this respect the IBA provides foreign banks better than national treatment. A foreign banking organization is permitted under Section 2(h)(2) of the BHCA, which was added by the IBA, to own shares of a foreign nonbanking company that engages in otherwise prohibited activities in the United States, as long as the company is principally engaged in business outside the United States. If the foreign nonbanking company in the United States is a subsidiary, additional limitations apply -- the activities in the United States must be the same kinds of activities conducted outside the United States, and the company may engage in banking or financial operations in the United States only with the prior approval of the Board. This nonbanking company exemption prevents disruption in overseas affiliations that are permissible under foreign law.

[2] See 17 CFR 32.4(a).

[3] 17 CFR 18

[4] See 12 CFR 225.25(b)(18) and (19)

[5] See Statutory Interpretation Concerning Certain Hybrid Instruments, 55 Fed. Reg. 13582, 13586 (April 11, 1990).

[6] See the definition of the term "foreign broker" in Commission Regulation 15.00(a)(1).

[7] Institute of International Bankers, "Economic Benefits to the United States from the Activities of the International Banking Community," May 18, 1989, pp. 49-54.

[8] See Exchange Act Release No. 27017 (July 11, 1989).

[9] See Exchange Act Release No. 27018 (July 11, 1989).

[10] See Investment Company Act Release No. 13691 (December 23, 1983).

[11] See Investment Company Act Release No. 16093 (October 29, 1987).

[12] See Securities Act Release No. 6661 (September 23, 1986).

[13] See Exchange Act Release No. 24634 (June 23, 1987).

[14] See Securities Act Release No. 6568 (February 28, 1985).

[15] See Securities Act Release No. 6841 (August 3, 1989).

[16] See Securities Act Release No. 6841 (August 3, 1989).

[17] See Securities Act Release No. 6866 (June 6, 1990).

[18] See Securities Act Release No. 6863 (April 23, 1990).

[19] See Securities Act Release No. 6862 (April 24, 1990).

[20] See Securities Act Release No. 6806 (October 25, 1988).

[21] See Exchange Act Release No. 27956 (April 27, 1990).

[22] See Exchange Act Release No. 24634 (June 23, 1987).

[23] See Exchange Act Release No. 27554 (December 20, 1989).

[24] See Exchange Act Release No. 26612 (March 8, 1989).

[25] Blue Sky Law Reporter, Volume 1, Commerce Clearing House, Inc., 1984, paragraph 501.

[26] The discussion of state Blue Sky Laws is based, in part, on 12 J. Long, Blue Sky Law, 1-1-1-19 (1989).

[27] Blue Sky Law Reporter, Volume 1, Commerce Clearing House, Inc., 1984, paragraph 5500.

[28] H.R. Rep. No. 1983, 93rd Cong., 2d Sess. at 35 (1974).

[29] See Commission rule 4.5, 17 CFR 4.5 (1989).

[30] See, e.g., large trader reporting obligations of traders, 17 CFR 18.00 (1989), and the record-keeping requirements in Commission rule 1.31, 17 CFR 1.31 (1989).

[31] "Foreign brokers" are subject to reporting requirements in Parts 15-21 of the Commission's regulations. See, e.g., Interpretative Letter No. 89-11, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. Paragraph 24,517 (August 15, 1989). See also 48 Fed. Reg. 35248, 35261 (August 3, 1983).

[32] See generally Interpretative Letter No. 76-21 [1975-1977 Transfer Binder] Comm. Fut. L. Rep. Paragraph 20,222 (August 15, 1976).

[33] Interpretive Letter No. 87-10, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. Paragraph 23,999 (December 9, 1987).

[34] See Commission Regulation 30.5.

[35] Consistent with Section 4(b) of the CEA, the Commission has not asserted jurisdiction over the terms and conditions of contracts traded on foreign exchanges, the rules governing the trading of such contracts, or the organization or administration of foreign exchanges.

[36] Failed Promises, Insurance Company Insolvencies, A Report by the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives, Washington, February 1990.

2. Operations of Foreign Financial Institutions in the U.S.

FOREIGN BANKS

Foreign banks have had an important presence in the United States for over 100 years. Although their presence has grown rapidly in the 1980s, this is not a new phenomenon in U.S. history. After the Civil War foreign banks helped finance the growth of U.S. railroads and many other major industrial projects. In 1880, British banks owned the third and fourth largest California banks and held 15 percent of all deposits in that state. Canadian and Asian banks also had operations there. The operations of nearly 250 foreign bank agencies, branches and subsidiaries were grandfathered under the International Banking Act of 1978. By the mid-1980s, most major international banks had established a presence in the U.S.

As of June 30, 1990, 284 foreign banks from 58 countries maintained 589 branch and agency offices, 99 U.S. bank subsidiaries, 23 Edge corporations, and 10 New York State investment companies in the United States. (An agency is a state-chartered foreign bank office which may lend and maintain credit balances, but not accept deposits. Edge corporations are federally chartered international banking or financing corporations organized under Section 25(a) of the Federal Reserve Act. They give U.S. banks flexibility to provide international banking services within the United States and to make investments abroad. Their domestic activities are strictly confined to foreign or international transactions.) As of June 30, 1990, there were 453 representative and loan production offices from 59 countries. Many international banks maintain representative and loan production offices in more than one state. Foreign banks also operate in the United States through a variety of nonbanking subsidiaries such as broker-dealers, leasing and finance companies, investment advisers and limited purpose trust companies.

Total assets of the U.S. banking operations of foreign banks and subsidiaries was $734 billion as of June 30, 1990. Of the total, 362 branches held $475 billion (65 percent), U.S. bank subsidiaries of foreign banks held $153 billion (21 percent) and 227 agencies held $99 billion (13 percent). Sixty branches of 27 banks from 14 countries had federal deposit insurance coverage of U.S. branch deposits, as required by the IBA for deposits under $100,000 of U.S. residents.

As of December 31, 1989, approximately 48 percent of the assets of foreign bank branches and agencies were booked in international banking facilities (IBFs) as credits made to borrowers outside the U.S. (IBFs allow U.S.-chartered depository institutions, U.S. offices of Edge and Agreement corporations, and U.S. agencies and branches of foreign banks to conduct banking business with foreign residents in a regulatory environment broadly similar to that of the Eurocurrency market.)

Japanese banks have the largest presence of any national group of foreign banks in the U.S., with 55 percent of foreign-controlled banking assets and 11 percent of total U.S. banking assets. They are followed at considerable distance by banks from Italy, Canada and the United Kingdom with 6.4 percent, 5.4 percent and 5.2 percent of foreign-controlled assets, respectively. The majority (65 percent) of foreign banking assets are held in branches.

Foreign banks operate primarily in the large U.S. financial centers, such as New York, Los Angeles, San Francisco, Chicago, Miami, Atlanta and Houston. Many have branches grandfathered under the IBA in two or more of these banking centers.

Nearly all (98 percent) of the commercial bank assets held by foreign banks are at offices located in 10 U.S. cities. Most of these are in New York City, which had $509 billion or 69 percent of total commercial bank assets held by foreign banks. The highest levels of market penetration by foreign banks are also in New York where foreign banks hold 60 percent of total business loans and 57 percent of total commercial bank assets, and in California where foreign banks hold 51 percent of business loans and 32 percent of total commercial bank assets.

Activities of foreign banks in the U.S. are mainly focused on wholesale operations with corporations and other banks. Their activities, in order of importance, include corporate finance, correspondent banking, money market activities, trade financing, loan syndications and foreign exchange. The services are traditionally provided for clients from their home markets with business or operations in the U.S.

Foreign banks in the U.S. have different strategies for competing in the U.S. market. Besides wholesale banking, some also provide credit service, real estate finance and private banking services. Recently many have begun to seek more U.S. domestic middle market corporate business and pursue new opportunities in investment banking services, such as providing mergers and acquisitions advice.

Nevertheless, some very large commercial banks in the U.S. are foreign-controlled subsidiaries of foreign banks which offer a full range of banking services, including retail banking. For example, Marine Midland Bank, owned by Hongkong and Shanghai Banking Corporation, has total assets of over $20 billion. Union Bank, owned by Bank of Tokyo, has total assets of over $15 billion; National Westminster Bank, USA has total assets of over $14 billion; and First National Bank of Maryland, controlled by Allied Irish Bank Limited, has total assets of over $6 billion.

While it is difficult to generalize about individual banks' special areas of interest, the following observations can be made: United Kingdom banks are active in all areas of commercial banking activity. Japanese banks engage in retail banking in the state of California, while French and West German banks have shown little interest in retail banking at any location. Banks from developing countries are generally active in trade financing.

Major Areas of Services of Foreign Banks in the United States:

General Banking
    Correspondent banking
    Private banking
    Credit services

Management Services
    Investment management
    Document safekeeping and services

Investment Services
    Security underwriting
    Security trading
    Venture capital
    Financial commodity dealing

Loans and Leasing

- Corporate financing
- Trade financing
- Loan syndication and leasing
- Energy and project financing
- Real estate financing
- Mergers and acquisitions
- Factoring

Money Market

- Foreign exchange dealing
- Currency note dealing
- Certificates of deposit
- Forfeiting
- Promissory note discounting
- Issuance-trading of letters of credit and bills of lading
- Import-export drafts

(Note: Exposure data in the schedules in this chapter may vary from data reported in the individual country chapters due to different time frames and other parameters.)

Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks

December 31, 1989 $ Billion	Total	IBF only
Total Assets	579.5	276.6
Cash & due from depository institutions	145.6	124.2
Total Securities	37.7	12.3
Federal Funds sold	20.3	4.5
Total loans, gross	261.3	65.0
Less: Unearned income	(.2)	-.-
Loans, net:	261.1	65.0
Real estate loans	30.2	.3
Depository institutions	61.4	31.5
Commercial and industrial	138.2	16.0
U.S. domicile	117.5	.3
Non-U.S. domicile	20.7	15.7
Other	31.5	17.2
All other assets	55.0	8.2
Customers liab. on acceptances	33.4	-.-
Other assets	21.6	8.2
Net due from related depository institutions	59.8	62.4
Total Liabilities	579.5	276.6
Total deposits and/ credit balances	269.7	192.1
Ind.,ptnrshps, corps.	78.9	16.0
U.S. domicile	49.5	.7
Non U.S. domicile	29.4	15.3
Comm. banks in U.S.	70.5	60.1
U.S. office foreign bks.	56.6	51.5
Other banks	13.9	8.6
Banks in foreign countries	107.7	106.1
Foreign official institutions	10.7	9.6
Other	1.5	.2
Certified/official checks	.4	-.-
Federal funds purchased	51.7	6.3
Other borrowed money	129.8	40.3
Nonrelated banks in U.S.	0.3	15.3
Nonrelated banks not in U.S.	23.8	23.1
Owed to others	25.7	1.9
All other liabilities	53.6	7.4
Net due related depository institutions	74.7	30.5

Source: Federal Reserve

U.S. Offices of Foreign-Controlled Banks
June 30, 1990

By type of organization:	Number	Total Assets $ Billions
Agencies	227	99
Branches	362	475
Banks	99	153
Investment Cos.	10	4
Edge/Agreement Cos.	23	3
Total	721	$734
Total U.S. commercial bank assets		$3,586
Percent foreign-controlled		20

Source: Federal Reserve

Ten U.S. Cities with the Most Foreign Banking Offices
June 30, 1990

Cities	Agency	Branch	Bank Sub.	Edge Act	Inv. Co.	Rep. Off.	Total Offices	Total Assets $ Bil.
New York	37	236	40	6	10	211	536	$509
Los Angeles	68	32	15	0	0	30	139	83
Chicago	0	53	4	2	0	34	95	55
Houston	16	0	0	3	0	52	73	3
Miami	46	0	4	9	0	12	71	13
San Francisco	27	8	6	2	0	21	69	46
Atlanta	24	0	0	0	0	12	36	7
Dallas	5	0	0	0	0	15	20	1
Washington D.C.	0	4	0	1	0	9	14	1
Seattle	0	8	0	0	0	4	13	2
Ten Cities	223	341	69	23	10	400	1066	$720
Total Foreign U.S. Offices	227	362	99	23	10	453	1198	$734

Source: Federal Reserve, U.S. Treasury

U.S. Assets of Foreign-Controlled Banks - 10 Leading Countries
June 30, 1990

$ Billions

Country	Total Assets	Percent Foreign	Percent of Total U.S. Bank Assets
Japan	404	55.0	11.3
Italy	47	6.4	1.3
Canada	40	5.4	1.1
U.K.	38	5.2	1.1
France	33	4.5	.9
Hong Kong	24	3.3	.7
Switzerland	22	3.0	.6
Germany	17	2.3	.5
Netherlands	12	1.6	.3
Israel	10	1.4	.3
Total	$647	88.1	18.1

Source: Federal Reserve

Foreign bank activity in the U.S.

Country	Total Assets ($M)	Operating Offices	Bank Families
Japan	404,403	143	45
Italy	46,586	26	13
Canada	40,369	52	7
U.K.	38,407	42	11
France	33,229	37	13
Hong Kong	23,856	29	10
Switzerland	22,374	19	6
Germany	16,976	25	13
Netherlands	12,299	24	4
Israel	10,466	27	4
Spain	8,619	24	7
Ireland	8,296	9	2
Korea	6,366	25	7
Australia	5,799	19	7
Sweden	5,539	5	3
Mexico	4,599	14	6
Brazil	4,532	27	15
Taiwan	3,285	8	3
Belgium	3,281	6	4
Austria	2,785	4	3
Venezuela	2,520	18	7
Finland	2,393	3	3
Indonesia	2,304	8	7
Denmark	1,582	6	3
Greece	1,186	4	1
Portugal	1,182	5	4
China	1,170	3	1
Bahrain	1,071	3	3
Norway	1,020	5	3
Thailand	1,010	9	5
Argentina	887	5	3
Yugoslavia	882	3	3
India	836	9	3
Pakistan	835	6	3
Singapore	821	9	5
Kuwait	811	3	2
New Zealand	806	1	1
Colombia	803	7	5
Malaysia	721	3	2
Luxemburg	504	4	1
Turkey	435	1	1
Saudi Arabia	417	2	2
Uruguay	356	1	1
Philippines	350	9	6
Panama	332	3	3
Ecuador	251	2	2
Bermuda	207	1	1
U.A.E.	181	4	3
Jordan	169	2	2
Other	6,010	15	13
Total	734,118	719	284

Selected Assets and Liabilities of U.S. Offices of Foreign Banks[1]

	Amount ($ Billions)				Share of U.S. Market[2] (Percent)			
	Total Assets	Total Loans	Bus. Loans	Total Dep.	Total Assets	Total Loans	Bus. Loans	Total Dep.
December								
1973	32.3	17.6	12.8	11.4	3.8	3.7	7.6	1.7
1974	48.1	27.0	18.8	17.0	4.9	5.1	9.5	2.3
1975	52.4	29.9	19.9	22.6	5.3	5.7	10.4	2.9
1976	61.3	35.4	19.7	26.1	5.8	6.4	10.2	3.1
1977	76.8	41.5	22.0	33.8	6.4	6.6	10.3	3.6
1978	109.1	65.3	32.7	46.3	8.0	8.8	13.1	4.5
1979	149.6	91.9	48.2	62.8	9.9	10.9	16.3	5.6
1980	200.6	121.4	59.6	80.4	11.9	13.4	18.2	6.6
1981	250.6	157.7	73.8	101.8	13.5	15.4	19.2	7.7
1982	299.8	185.2	82.4	154.3	14.4	16.3	18.8	10.4
1983	328.8	192.4	84.5	181.3	14.6	15.6	18.3	11.1
1984	394.4	220.1	87.8	233.7	15.0	15.1	21.6	12.9
1985	440.8	247.4	108.8	236.7	16.1	15.4	22.5	12.1
1986	524.3	276.9	126.8	278.2	17.3	15.6	23.3	12.8
1987	582.6	310.9	147.9	316.1	19.0	16.6	26.4	14.1
1988	650.8	338.8	157.3	335.1	19.6	16.9	28.2	14.1
1989	735.7	369.8	184.3	376.1	20.6	17.2	29.4	14.9
June								
1990	731.1	376.1	184.1	349.1	20.4	17.3	29.4	13.8

Sources: FFIEC 002, FFIEC 031, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

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[1] Data include agencies, branches, subsidiary commercial banks and New York investment companies, but not Edge or Agreement Corporations. U.S. offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. U.S. offices of Puerto Rican banks are not included.

Selected Assets and Liabilities of New York Offices of Foreign Banks[1]

	Amount ($ Billions)				Share of New York Market [2] (Percent)			
	Total Assets	Total Loans	Bus. Loans	Total Dep.	Total Assets	Total Loans	Bus. Loans	Total Dep.
December								
1973	22.2	12.6	9.0	6.2	13.0	12.9	19.2	8.8
1974	31.3	18.8	13.1	12.6	15.8	16.3	21.8	8.9
1975	35.8	20.5	13.8	16.4	18.3	19.0	24.5	11.8
1976	42.4	24.5	13.0	18.9	20.5	22.4	24.2	13.4
1977	54.1	28.6	14.4	25.5	22.4	24.2	25.6	16.0
1978	76.2	48.5	21.2	36.0	26.9	32.2	31.8	20.0
1979	100.6	62.7	30.6	44.9	31.1	36.5	36.5	23.5
1980	134.8	83.3	38.0	59.1	36.0	42.4	41.5	27.9
1981	149.5	98.5	44.2	61.4	37.5	42.2	40.9	29.3
1982	189.7	114.8	49.2	105.7	39.5	42.4	39.4	38.7
1983	214.3	117.9	52.1	123.6	42.4	42.4	41.2	42.4
1984	253.9	130.7	59.3	156.4	43.2	41.2	43.5	45.5
1985	293.0	153.3	66.0	166.9	44.5	43.7	47.9	44.0
1986	366.6	178.5	80.6	212.1	48.4	44.2	49.9	47.2
1987	412.0	197.1	91.8	245.5	52.5	46.7	55.6	51.5
1988	454.0	213.2	103.0	258.4	54.6	48.5	59.1	51.7
1989	511.3	224.7	111.7	290.1	57.4	48.7	60.1	54.5
June								
1990	503.5	222.8	109.7	264.1	57.4	49.0	60.0	52.8

Sources: FFIEC 002, FFIEC 031, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

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[1] Data include agencies, branches, subsidiary commercial banks and New York investment companies, but not Edge or Agreement Corporations. New York offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. New York offices of Puerto Rican banks are not included.

Selected Assets and Liabilities of California Offices of Foreign Banks[1]

	Amount ($ Billions)				Share of California Market[2] (Percent)			
	Total Assets	Total Loans	Bus. Loans	Total Dep.	Total Assets	Total Loans	Bus. Loans	Total Dep.
December								
1973	9.5	4.5	3.3	2.9	9.9	8.2	15.5	4.1
1974	13.3	7.0	4.6	4.0	12.6	11.5	18.7	5.1
1975	14.5	7.8	4.8	5.4	12.9	13.0	20.4	6.2
1976	15.9	8.8	5.1	6.2	13.5	13.9	22.3	6.9
1977	18.0	9.96	5.4	7.2	13.9	13.4	21.3	7.1
1978	27.1	14.3	8.1	9.0	16.9	15.5	25.8	7.9
1979	38.1	21.6	12.0	14.8	21.4	19.4	31.1	12.0
1980	50.1	26.7	13.3	16.1	24.2	21.1	30.9	11.7
1981	79.7	46.7	20.2	31.3	33.3	31.5	39.7	20.3
1982	86.3	53.9	23.3	38.6	33.3	32.8	39.5	22.4
1983	88.5	57.2	22.6	46.4	32.8	33.0	38.4	24.4
1984	98.8	62.9	25.0	36.4	35.0	32.6	40.3	27.4
1985	100.8	63.3	26.2	49.1	33.7	31.3	41.5	23.7
1986	98.9	61.6	26.6	40.3	30.8	28.8	38.4	18.3
1987	106.7	65.7	29.7	39.4	34.1	31.1	43.1	18.8
1988	112.0	71.8	33.5	43.4	33.2	31.5	47.1	19.1
1989	120.2	80.5	38.2	42.7	32.4	30.8	48.8	17.3
June								
1990	129.2	89.4	40.8	45.1	32.8	31.6	50.6	17.6

Source: FFIEC 002, FFIEC 031, FFIEC 032, FFIEC 033, FFIEC 034, FR 886a, and FR 105.

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[1] Data include agencies, branches and subsidiary commercial banks, but not Edge or Agreement Corporations. California offices of Puerto Rican banks are not included. Assets and liabilities include those on the books of International Banking Facilities (IBFs).

[2] Includes "domestically owned" commercial banks, U.S. agencies and branches of foreign banks, and commercial banks and New York investment companies with more than 25 percent foreign bank ownership, but not Edge or Agreement Corporations. California offices of Puerto Rican banks are not included.

FOREIGN SECURITIES BUSINESSES

Federal securities laws in most cases provide national treatment for persons engaged in the securities business within the United States. With the exception of foreign government entities and foreign banking institutions, foreign issuers are subject to substantially the same requirements as U.S. issuers.

Brokers and Dealers

A broker-dealer (other than a U.S. bank) doing business in the United States generally must register under the Exchange Act. The SEC's policy is one of equal market access in that the SEC seeks to apply the same requirements to all broker-dealers, whether U.S. or foreign-owned or U.S. or foreign resident.

Registered broker-dealers are not required to report to the SEC the extent to which they are owned by foreigners. That fact is itself an indication of the extent to which national treatment is accorded to foreign-owned broker-dealers. Foreign ownership of 10 percent or more in a broker-dealer resident in the U.S. is, however, required to be reported to the Commerce Department's Bureau of Economic Analysis. Commerce Department data on investment in broker-dealers are not available separately but are included in the "other finance" category in the direct investment statistics.

SEC staff estimates that the number of registered broker-dealers in which foreign persons have equity interests of 25 percent or more may be approximately 130. The total may include companies doing business in the U.S. from abroad. The domiciles of the foreign owners of these approximately 130 broker-dealers are in the following countries:

Domicile of Owners	Number of Broker-Dealers
Australia	8
Austria	1
Canada	15
France	7
Germany	15
Hong Kong	4
Israel	1
Italy	1
Japan	18
Korea	1
Liechtenstein	1
Netherlands	4
Panama	2
Switzerland	11
United Kingdom	38

Investment Advisers

Under the Investment Advisers Act of 1940 (IAA), foreign investment advisers that use the U.S. mails or any means or instrumentality of interstate commerce in connection with their business are required to register with the SEC, unless an exemption is available. No particular qualifications are required for registration, and the SEC seeks to apply the same requirements to foreign and domestic investment advisers.

Approximately 200 foreign investment advisers, with foreign business addresses, are currently registered with the SEC. In addition, the SEC believes that there are a small number of foreign investment advisers who used U.S. addresses when registering. Based on their registration forms, it appears that a substantial majority of the approximately 200 foreign investment advisers, with foreign business addresses, have 50 or fewer clients and that less than 10 of these advisers have more than 500 clients. These approximately 200 advisers have reported an aggregate market value of approximately $281 billion of client securities managed on a discretionary basis and $71 billion of client securities managed or supervised on a nondiscretionary basis. These advisers report giving advice to a broad range of types of clients, including individuals, banks and thrifts, investment companies, pension and profit sharing plans, and corporations. Approximately one-eighth of these advisers have reported that their principal business (or the principal business of their principal executive officers) involves something other than providing investment advice.

The business addresses of the approximately 200 registered foreign investment advisers with foreign business addresses, are in the following countries:

Business Address	Number of Investment Advisers
Australia	5
Austria	2
Bahamas	3
Belgium	2
Bermuda	3
Bolivia	1
Brazil	1
Canada	23
Chile	1
Republic of China	2
Egypt	1
France	2
Germany	10
Gibraltar	1
Greece	1
Hong Kong	10
India	1
Republic of Ireland	9
Japan	22
Republic of Korea	6
Malaysia	1
Mexico	2
Netherlands	3
Netherlands Antilles	2
Norway	1
Portugal	1
Spain	3
Sweden	1
Switzerland	3
Thailand	1
Turkey	2
United Kingdom	73

Investment Companies

The Investment Company Act of 1940 (ICA) requires registration with the SEC of all non-exempt investment companies. Under section 7(d) of the ICA, a foreign investment company -- one not "organized or otherwise created under the laws of the United States or of a State" -- may not, in connection with a public offering, offer for sale, sell, or deliver its securities through the mails or interstate commerce unless the SEC by order finds that "it is both legally and practically feasible effectively to enforce the provisions of (the Investment Company Act) against such company." This standard is difficult to meet, particularly for funds organized in civil, rather than common law countries.

In order for any foreign investment company to sell securities in the U.S., the SEC must find that investors have the same protections as investors in domestic investment companies. Currently, three Canadian companies and one South African company are registered with the SEC. As the SEC standard is difficult to meet, the SEC has suggested an alternative for foreign money managers, which is to organize an investment company in the United States that "mirrors," or invests in the same type of securities as, the foreign investment company, and registers the mirror fund to sell its shares in the United States. A growing number of publicly offered U.S. investment companies invest in foreign securities. Many of these so-called international funds are thought to be mirror funds.

As of December 31, 1985, there were 68 U.S. investment companies whose portfolios consisted primarily of foreign securities. Total assets in these companies amounted to approximately $11.9 billion. As of March 31, 1990, the number of such U.S. investment companies had increased to 215; of these, 159 were open-end funds (that is, funds having a floating number of outstanding shares and standing prepared to sell or redeem shares) with total assets of approximately $19.3 billion and 56 were closed-end funds (that is, funds having a fixed number of outstanding shares which are traded either on an exchange or in the over-the-counter market) with total assets of approximately $10.1 billion. The March 31, 1990 figures do not include 49 U.S. open-end funds, with total assets of approximately $17.1 billion, that invest at least 25 percent of their portfolios in securities traded outside the United States, some of which may invest primarily in foreign securities.

Issuers

The Securities Act of 1933 (Securities Act) prescribes disclosure and antifraud standards for offering of securities in the United States, and requires registration of securities prior to their offer or sale unless an exemption from registration is available. Separate registration and reporting forms for foreign private issuers have been adopted under both the Securities Act and the Exchange Act.

Annual and other periodic reports are filed with the SEC by approximately 450 foreign issuers. The countries of incorporation of those issuers are as follows:

Country of Incorporation	Number of Issuers
Australia	12
Bahamas	2
Barbados	1
Bermuda	12
Bolivia	1
Botswana	1
British Virgin Islands	3
Canada	243
Cayman Islands	7
Costa Rica	1
Denmark	1
Finland	2
France	3
Greece	2
Hong Kong	3
Republic of Ireland	5
Israel	28
Italy	3
Japan	19
Liberia	4
Liechtenstein	1
Luxembourg	1
Mexico	1
Monaco	1
Netherlands	11
Netherlands Antilles	7
New Zealand	2
Norway	3
Philippines	4
South Africa	1
Spain	7
Sweden	8
United Kingdom	45
Zambia	1

FOREIGN COMMODITIES BUSINESSES

The Commodity Exchange Act (CEA) and the regulations thereunder regulate all transactions involving futures and certain option contracts as elaborated in Chapter 1. Under the CEA, a foreign firm considered to be doing business in the United States is treated no less advantageously than a domestic firm. Any person who acts in the capacity of a futures commission merchant (FCM), introducing broker (IB), commodity trading advisor (CTA), commodity pool operator (CPO), or as an associated person (AP) of the foregoing must register in the appropriate capacity with the Commodity Futures Trading Commission (CFTC).

In general, a financial intermediary will be deemed to be subject to CFTC regulation if it is legally domiciled in the U.S., is physically present in the U.S., has consented to jurisdiction or is considered to be conducting business in the U.S. A financial intermediary that is deemed to be conducting business in the U.S. need not be physically present in the U.S.

Under the CEA, the CFTC's policy is one of equal access. A foreign firm considered to be doing business in the United States is treated no less advantageously than a domestic firm.

Commission data, as of September 1989, indicate that the numbers of registrants who are foreign-based are as follows: 46 CTAs (1.9 percent of registrants), 18 CPOs (1.4 percent), 3 IBs (less than 1 percent) and 0 FCMs. The countries of origin for these registrants are as follows:

	CTA	CPO	IB
Australia	2	1	0
Bermuda	0	3	0
Belgium	1	0	0
Cayman Islands	0	1	0
Canada	21	5	2
England	9	4	0
Germany	3	0	0
Hong Kong	2	1	0
Mexico	1	0	0
Monaco	1	0	0
New Hebrides	1	0	0
New Zealand	1	1	0
Switzerland	1	0	0
Taiwan	1	0	0
Venezuela	0	0	1
West Indies	2	2	0
Total	46	18	3

The extent to which CFTC registrants, including FCMs, are foreign-owned directly or indirectly, in whole or in part, is unknown because neither the degree of ownership interest in nor the address of the parent firm of the registrant is required to be disclosed on CFTC registration documents. The CFTC is in the process of requiring the disclosure of this information in the registration form.

CFTC rules also provide special treatment for firms engaging in the offer or sale of foreign futures and commodity option products to persons in the United States. Specifically, CFTC rules provide a mechanism for exempting foreign firms, upon application by relevant parties, from compliance with some CFTC rules, such as registration, based upon the CFTC's determination of comparability between the foreign jurisdiction's regulatory scheme and that of the CFTC. This approach of substituted compliance is an effort to avoid duplicative regulation without having regulatory gaps. The countries of origin of these exempted firms are as follows:

Foreign Firms Granted Relief from
Registration as FCMs Based upon
Comparability of Foreign Regulation

Australia	6
Canada	7
Singapore	2
United Kingdom	64
	79

FOREIGN INSURERS

Foreign insurance companies participate actively and successfully in the United States market. As the United States regulatory system offers them full equality of competitive opportunity, they have chosen to organize themselves in a number of different ways. By offering a wide range of insurance products, they have built up their market share in this country's insurance industry. They have made substantial inroads to other segments of the U.S. financial services industry as well.

Foreign Participation in Insurance Services

Most of the insurance in the United States provided by foreign firms comes either directly from foreign-based entities or through U.S.-based insurers owned by foreign entities. U.S. insurance affiliates of foreign direct investors (U.S. insurance establishments, including branches and subsidiaries, owned 10 percent or more by foreign persons) received approximately $33 billion of premiums in 1987, or about 8.1 percent of total U.S. premiums, based on Department of Commerce statistics. This performance was bolstered by a strong representation in the three main segments of the U.S. industry: life insurance, nonlife insurance and reinsurance.

In the life insurance sector, U.S. life insurance affiliates of foreign direct investors accounted for approximately $12 billion of premiums in 1987, about 5.5 percent of the market. In the nonlife insurance sector (which includes reinsurance), U.S. nonlife insurance affiliates of foreign direct investors received approximately $21 billion of premiums in 1987, about 10.5 percent of the U.S. nonlife market.

It is, however, the field of reinsurance which evidences the strongest international representation of the major sectors of the industry. In 1989, it is estimated that over $8 billion in U.S. reinsurance premiums went to insurance companies based outside the United States, nearly a third of all U.S. reinsurance premiums. After losses paid, net premiums amounted to $2.8 billion. Western Europe (especially the United Kingdom) and the offshore centers (Bermuda, Bahamas, etc.) accounted for most of this amount. In addition, over 35 of the most prominent U.S.-based reinsurers are branches and subsidiaries of foreign insurance companies. Of the five largest U.S. reinsurers, two (Munich Re and Swiss Re) are foreign-owned.

Foreign-based insurers are also very active in the relatively small but important U.S. surplus lines business in which coverage is provided by non-established insurers for certain businesses that established insurers are unable or unwilling to underwrite.

Across all segments of the industry, firms from Canada, the United Kingdom, the Netherlands and Switzerland, in that order, accounted for over 70 percent of assets and sales of foreign direct investors in the insurance business in the United States in 1987. The penetration of foreign insurers in the U.S. market is high when compared with the market penetration of foreign insurers in most other major markets. Foreign insurers in the United States have a substantially higher share of the market than foreign insurers operating in Japan, Germany, the United Kingdom, and Switzerland.

There is every evidence that the foreign market share of the U.S. insurance industry has greatly expanded since 1987, as foreign insurers have been increasingly active in acquiring U.S. operations. The largest and most prominent recent acquisition of a U.S. insurance company was the 1988 purchase of Farmers Group of Los Angeles, a large multiline insurance group, by Batus Inc., the U.S. subsidiary of B.A.T. Industries PLC of the United Kingdom for $5.2 billion. In a deal expected to be consummated in early 1991, the large German insurer, Allianz AG Holding, will acquire the Firemen's Fund Insurance Co. for $3.3 billion, pending regulatory review and stockholder approval.

Other recent acquisitions include purchases by Aegon NV of the Netherlands of Monumental Life of Baltimore and Washington National Life of Evanston, Illinois. Most recently, in June 1990, Assicurazioni Generali SpA, an Italian insurance company, purchased Business Men's Assurance Company of Kansas City, Missouri.

Range of Insurance Services Being Offered

Foreign-owned insurance companies are permitted to offer any product that domestically owned companies are allowed to offer under the law.

A few specific examples will illustrate and represent the wide range of product types offered by foreign insurers. Nationale-Nederlanden NV, the largest insurance group in the Netherlands, offers a full range of insurance services in the United States through a number of subsidiaries. Southland Life Insurance Company of Texas, acquired in 1989, is one of seven U.S. subsidiaries that offer life insurance and related products. Nationale-Nederlanden has five fully owned subsidiaries that write property/casualty insurance, while four handle accident and health insurance.

Dai-Ichi Mutual Life Insurance Company of Japan operates under an agreement with Phoenix Mutual Life of Hartford, Connecticut, in which Phoenix markets group policies to U.S.-based Japanese companies, which are in turn reinsured with Dai-Ichi. Dai-Ichi has similar arrangements with other U.S. insurers. In 1990, the firm also purchased 9.7 percent of Lincoln National Life, the prominent U.S. life reinsurance company.

Another Dutch multiline insurance company, Aegon NV, obtained approximately 45 percent of its corporate revenue from the United States in 1987 through its holding company, Aegon USA in Baltimore. Aegon has six U.S. subsidiaries that write nearly all forms of insurance including property/casualty reinsurance, life, disability, group, and accident and health.

Diversification Into Other Financial Services

Under United States law foreign insurers can engage in other financial services as well. In the United States, insurance companies can be organized as independent entities or controlled by holding companies. Upstream insurance holding companies can be formed by one or more stock insurance companies and are generally not subject to direct insurance regulatory supervision. In addition to their stock insurance subsidiaries, insurance holding companies are permitted to own subsidiaries engaged in virtually any other sector, except banking.

Through the holding company vehicle, many insurers can engage in a broad range of financial service activities, including many that closely resemble banking. The insurance holding company structure has resulted in the emergence of companies providing "full financial services," most often marketed by the insurer's sales force.

These companies market insurance, investment banking and some bank like products. One example is the issuance of financial guaranties, an insurance product that is the functional equivalent of a bank letter of credit. Most financial guaranties are issued by special purpose insurance companies rather than traditional property and casualty insurers, because of the special underwriting expertise required. Another bank-like product marketed through this mechanism is the "cash management account" with its checking account feature available through investment banking affiliates.

Some Japanese insurance companies have been active in other financial service sectors. In 1987, Nippon Life Insurance Company acquired part of Shearson Lehman Brothers, while Yasuda Mutual Life Insurance Company bought part of PaineWebber Group. Both these investments are in the investment banking sector. In 1988, Dai-Ichi Mutual Life Insurance Company acquired a 20 percent interest in La Salle Partners Ltd., Chicago, a large, privately held real estate firm. In 1989, Dai-Ichi also acquired a financial interest in Goldman Sachs, another U.S. investment bank. Also that year, Tokio Marine and Fire acquired 10 percent of Delaware Management Holdings Inc., a private investment firm in New York.

Insurers from other countries have also been expanding into other U.S. financial service sectors. Crown Life Insurance Company of Canada, which receives most of its corporate revenue from U.S. subsidiaries, owns a securities brokerage firm, Private Ledger Financial Services, and a health care cost management firm, U.S. Administrators Inc. Aegon NV, in addition to its extensive insurance operations, also operates a general equipment leasing company, LeaseAmerica; a real estate management firm, Aegon USA Realty Advisors Inc.; and a securities-related investment management firm, MidAmerica Management Corp. National Nederlanden NV is a partial owner of AIM Management Group, a large mutual fund company with a wide variety of funds available.

It is clear that especially those insurers coming from a home country with a tradition of universal banking (such as Germany) are well-positioned to eventually take full advantage of the U.S. market, not only across all product lines of the traditional insurance market, but if permitted, throughout the range of financial services, including banking and securities.

The United States is the largest and one of the most open insurance markets in the world. Foreign insurers have moved aggressively in recent years in a variety of modes and in nearly every market segment to capitalize on the attractive opportunities that are available. There is every indication that the market penetration of foreign insurers will continue, as well as the diversification of a number of foreign companies into other financial services.

3. Argentina - Banking

SUMMARY

Argentina has a large number of banks, producing a difficult environment for banking operations. Its economy is currently in a serious recession. Of the 169 commercial banks active in the market, 10 are branches or fully owned subsidiaries of institutions in the U.S. and another involves a sizable U.S. capital investment. Local bankers and regulators agree that the U.S. banks currently in the market receive national treatment in the scope of financial activities they can pursue. The only form of discrimination is that domestic banks have the right of first refusal should another domestic bank decide to sell its branches. A layer of red tape was recently cut away from the procedures for establishing new banks in the Argentine market, but the Central Bank retains a great deal of discretionary power in its final decision. Since taking office in July 1989, the Menem administration has not been tested on its tolerance for the establishment of additional foreign banks in Argentina.

There is potential for improvement on entry, and only small deviations from national treatment affect established foreign banks in Argentina.

As of year-end 1989, ten U.S. banks operated 92 branches, with assets of $1.2 billion, and owned a controlling interest in 20 subsidiaries, with assets of $293 million in Argentina. This is a net increase of 22 branch offices and three subsidiaries, but a net decrease in U.S. bank controlled assets of $247 million since year-end 1985. At that time, U.S. banks had 70 branches in Argentina with total assets of $1.4 billion and a controlling interest in 17 subsidiaries or affiliates in Argentina with total assets of approximately $340 million. An additional 12 U.S. banks maintained representative offices there.

At the end of 1989, three Argentine banks operated four agencies, with assets of $579 million, and two branches, with assets of $534 million in the United States. Argentine banks maintain nine representative offices in the United States. This presence represents an increase of one agency and a decrease of one branch office and a net decrease in Argentine bank controlled assets of $435 million since year-end 1985. At that time, three Argentine banks operated three branches, three agencies, and one representative office in the U.S. with total assets of $1.5 billion. An additional seven Argentine banks maintained representative offices in the United States.

OVERVIEW

Domestic Banking Market

The banking industry in Argentina reflects the generally poor economic conditions in a country where economic activity has been depressed for the last two and a half years. Many banks in the Argentine market are ailing and the industry appears ready for a shakeout. The financial environment has long been dominated by government demands on bank deposits, through high reserve requirements. Such requirements have been a major factor in distorting the role of Argentine banks as financial intermediaries for the private sector.

The Argentine market is generally considered to be over-banked. As of September 1989, Argentina had 169 separate public and private commercial banks with more than 4,300 branches throughout the country. Argentina's gross domestic product (GDP) was equivalent to $71 billion in 1989. In contrast, Mexico, with a GDP of $136 billion, had 20 banks with total deposits of $53 billion.

As of September 1989, total deposits at commercial and investment banks in Argentina were $7.4 billion and total deposits in the banking system were $8.1 billion (according to data from a local bank association). Total commercial and investment bank loans outstanding in the Argentine domestic market were $5.9 billion.

Distribution of Austral Liabilities and Assets
Year-End 1989

Type of Bank	Number of Banks	Number of Branches	Percent of Deposits	Percent of Loans
Commercial	169	4,310	91.8	77.9
Publicly Owned	(31)	(518)	(35.0)	(43.5)
Private Domestic	(106)	(1,164)	(41.6)	(23.9)
Foreign-Owned	(32)	(406)	(15.2)	(10.5)
Investment	2			0.1
Public	(1)			
Foreign	(1)			
Development	2	33	1.6	10.5
Mortgage	1	53	0.5	5.4
Savings and Loan	1	52	3.5	3.5
Nonbanks				
Finance Companies	39	71	1.6	1.5
Credit Unions	23	5	0.2	0.2
Savings and Loan Societies	7	15	0.8	0.9
TOTAL	244	4,539	100.0	100.0

Source: Association of Argentine Banks (ABRA), *Annual Report for 1989*.

Sustained high inflation has made the dollar a favorite asset of Argentine savers, with perhaps $5 billion circulating in Argentina. In August 1989, local banks were allowed to open new dollar-denominated accounts to tap this resource. Reserve requirements on dollar accounts are no more than 20 percent, and are being held in the New York account of the state-owned Banco de la Nacion. The accounts are not guaranteed by the Central Bank. The total amount in these accounts has hovered around $1 billion since the accounts opened.

Banks are also divided into three categories by Central Bank authorities. The highest is category C for banks authorized to perform all types of transactions, including those involving dealings with foreign markets. Category B banks must perform foreign commercial transactions through a category C bank. Category A banks are excluded from export/import transactions. All foreign banks are in category C; domestic banks that have smaller capital bases and limited banking experience are in the more restrictive categories A and B.

Banking in Argentina is in transition. The deposit base was radically changed over the New Year's weekend of 1990. Previously, perhaps 65 percent of all deposits in the banking system were in the form of 7-day certificates of deposit (CDs). These CDs had funded the Government through a variety of Central Bank reserve requirements, which were actually forced loans from the banking system. A small portion of these required reserves was interest free, while the vast majority normally yielded a high real rate of return that was sufficient to cover the banks' interest cost to their CD depositors.

On January 1, 1990 the GOA decided it could no longer afford to pay such high rates. The Government unilaterally converted commercial bank required reserves at the Central Bank and their supporting CDs into 10 year, dollar-denominated bonds, paying a LIBOR-based rate. At this time, the Government, the banks, their depositors and the market are still sorting out the details of the conversion, and it is not possible to determine its long-term impact on the deposit base of the banking system.

Borrowing generally has played a minor role in Argentine business over the last few years. Because of the high rates of inflation and accompanying high rates of interest, banking and business community sources stated that companies in the Argentine market keep domestic borrowing to a bare minimum and only borrow to finance working capital needs. These sources estimate that the typical Argentine company relies most heavily on its own capital resources, partly built up in the past when negative interest rates on subsidized government loans were available. For those few that need financing now, capital comes from the following sources: retained earnings (70 percent); suppliers' credits (20 percent); loans from the financial markets (10 percent).

Banks act as lenders and as financial agents in the intercompany loan market. Currently, banks require very strict conditions for their lending. Loans are often fully collateralized with liquid assets. These conditions will not likely change significantly until Argentina's financial situation stabilizes for a considerable period.

U.S. Presence in the Market

Almost a third of all foreign banks located in Argentina have U.S. parents. Foreign banks hold roughly 15 percent of total deposits, of which U.S. banks hold nearly one-half. Of the U.S. banks in the Argentine market, one is an investment bank and the rest are commercial banks. In the commercial bank category, some American banks, such as the Bank of Boston, are more involved in retail banking, while others, such as Manufacturers Hanover, have concentrated on the wholesale side. U.S. commercial banks and their share of the Argentine market are listed in the following table:

U.S. Commercial Banks' Share of the Argentine Market

Banks	Percent of Total Deposits	Share Austral Loans
Bank of Boston	4.09	1.75
Citibank, N.A.	1.23	1.34
Chase Manhattan, N.A.	.79	0.50
Bank of America, S.A.	.18	.12
Continental Illinois	.12	0.34
Republic National of New York	.11	0.06
First National of Chicago	.09	0.13
Irving Austral	.06	0.16
Morgan Guaranty	.05	0.53
Manufacturers Hanover	.03	0.53
Share of Total Commercial Banks	6.75	5.46

Source: Association of Banks of the Argentine Republic, No. 129, September 1989.

Citicorp has a joint venture with a private Argentine bank that has 0.01 percent of the market's deposits and loans. Many of the U.S. banks have been in Argentina for some time. For example, Citibank recently celebrated its 75th year in the market, while the Bank of Boston has operated in Argentina since 1917.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Once a foreign bank is established in Argentina, it receives national treatment from banking authorities. These authorities have a great deal of discretion in allowing the establishment of new banks in the local market.

Argentine law divides banks by foreign and domestic ownership. Domestic banks are those with at least 70 percent Argentine capital. Of the 169 separate banks operating in Argentina in May 1989, 33 were foreign-owned.

The opening of new banks in Argentina is covered by basic bank law 21.526 of 1981. The law permits foreign banks to hold up to 100 percent of a local banking operation. No bank can buy more than 3 percent of another bank without Central Bank approval. Since November 14, 1989, the opening of a bank with foreign capital no longer requires a special presidential decree.

Currently, the only requirement for such an investment is the approval of the Central Bank Board, and registration with the Ministry of Economy. The Central Bank Board has the discretionary power to decide whether or not an investment in the banking sector (new bank, bank ownership transfers, etc.) is in the interest of the country. The board is not required to give a detailed reason for its decision. In making such a decision in the case of foreign investors, the Board is supposed to take into account: the effect on Argentina's foreign trade, competition in the domestic financial system, and whether Argentine banks are provided the same investment opportunity in the foreign bank's home country.

A bank can establish itself in the Argentine market in the form of an Argentine corporation, or as a branch of its home office. Once a bank entity is established in Argentina, it can seek permission to open local branches in other parts of the country. Bankers have told us that in practice, the Central Bank Board attempts to maintain a constant relationship between domestic and foreign banks in each city. Central Bank regulation 17.282 of 1986 specifies that in bidding on the liquidation of local branches of domestic banks, other domestic banks have the right of first refusal. U.S. bankers have said that this is the only discriminatory regulation they face, and that once established, foreign banks receive national treatment in the Argentine market.

In practice, however, the Central Bank currently is not taking applications for new banks, either domestic or foreign. The reason stated by banking authorities is the excess number of banks already in the market. The Central Bank has refused applications since 1984.

Foreign banks can also have representative offices in Argentina, which can promote loans through the home office. They are free to contact individuals as well as corporations. Representatives, however, are not authorized to collect deposits, lend, or receive repayments themselves, which distinguishes them from a locally established foreign bank.

CONCLUSION

There is potential for improvement on entry, and only small deviations from full national treatment affect established foreign banks in Argentina. Foreign banks are not legally prohibited from entry or expansion although the Argentine Government is not accepting applications for new banks, domestic or foreign, because they believe that an excessive number of banks already exists. However, foreign investors can enter the Argentine market through the purchase of insolvent local banks.

4. Argentina - Securities

SUMMARY

Argentina has formal stock markets in Buenos Aires and in five cities around the country. Traders in these markets must be individuals and all are currently Argentine nationals. Market officials maintain that there are no restrictions against a foreign individual buying a seat on the exchange. Some foreign firms have associated themselves with local seat owners. The equity market, however, is small, thin and volatile. There appears to be little interest among the local American brokers in becoming more involved in the domestic market.

Argentina also has an over-the-counter market. There are no restrictions on firms acting as agents. Some American bankers participate in this market, which basically consists of bond trading.

Financial instruments are primarily government bonds and corporate stocks. There are a number of mutual funds, often managed by local banks. Corporate bond issuance and financial futures trading are permissible under Argentine law, but neither have developed, in part because of unattractive market conditions, including high inflation. There is, however, a small futures market in agricultural goods.

There is no legal discrimination; however, U.S. firms have expressed little interest.

OVERVIEW

Domestic Securities Markets

Argentina's stock markets are small. The dominant market is in Buenos Aires. Smaller markets exist in five provincial cities around the country: La Plata, Mendoza, Pozario, Santa Fe, and Cordoba. There is also an active, growing over-the-counter market in Buenos Aires.

Financial instruments on the local market are divided into four general categories: stocks, federal government bonds, provincial government bonds and guarantees. In early 1990, average daily market activity on the Buenos Aires exchange had a value of $4 million with the following breakdown:

Activity in the Buenos Aires Market
(Example of Traded Instruments, Percent)

Federal Bonds (Bonex)	63.6
Stocks	27.1
Guarantees	8.7
Provincial Government Bonds	0.6

The market is shallow, and prices and volume are often volatile. For example, in 1989 inflation grew by almost 5,000 percent, and the increase in retail prices hit a peak of 200 percent on a monthly basis in July. During that time, the total daily value of transactions swung between a high of $30 million and a low of $1 million.

Organization of the Stock Exchange: Article 28 of Law 17-811 authorizes the various stock exchanges to manage the buying and selling of securities. The same law gives the Comision Nacional de Valores (CNV, National Securities Commission) oversight over the exchanges. The CNV is an autonomous body within the Government of Argentina (GOA). The exchanges are private nonprofit organizations. The Buenos Aires Exchange is owned by its 250 members. Approximately 210 members are active agents. Article 40 of the Law requires all members to be individuals. Some firms, however, have established relationships with the exchange through individuals. As of mid-year 1990, the exchange and the CNV were studying a proposal to allow firms to buy seats on the exchange.

Over-The-Counter Market: This market was founded in 1983 and is regulated by the CNV to ensure transparency. To help achieve this goal, an electronic network was begun in March 1989 that links the offices of agents in the market with the CNV. The network allows the CNV to record each transaction in the market as it occurs.

Agents in the market must pass certain financial requirements and demonstrate a physical presence in Argentina. Many national and foreign commercial banks are agents. Banks reportedly account for approximately half the agents in the market. The rest of the agents are independent. The market is devoted primarily to bond trading.

The bond market is composed almost exclusively of government debt, and is dominated by federal government bonds. Until the end of 1989, the federal government issued austral-denominated bonds, as well as bonds denominated and payable in U.S. dollars called Bonex (External Bonds). By the first week of 1990, the Government unilaterally converted the 19 different types of austral-denominated federal government bonds into Bonex. This eliminated the Government's volatile austral exposure, replacing it with longer-term, more predictable obligations. The Bonex is a 10-year bond that pays a variable interest rate based on LIBOR. The GOA has been careful to pay its Bonex obligations. An active secondary market exists, which has made these bonds attractive in the past.

Since 1904, Argentine law has provided for the issuance of corporate bonds, but such bonds have not played a significant role because of general financial instability.

Stocks: Argentine companies have made little use of stocks to raise capital. According to the Argentine Institute of Capital Markets, only $22.4 million was raised in 1987 and $25.1 million in 1988. Companies have generally been reluctant to open their boards of directors to outsiders. As a result, roughly 200 firms are listed on the Argentine Stock Exchange. Of these firms, only a handful have raised a sizeable portion of their capital through stocks.

Until recently, investment in stock was less attractive than investment in government bonds. Both income from and the equity value of stocks are taxed. As a result, only stocks of 25 companies listed on the exchange are actively traded. Recent reform of the tax system dropped the top income tax rate from 45 percent to 30 percent. It also reduced the tax on equity which could make stocks more attractive than in the past.

Mutual Funds: There are 29 mutual funds in the Argentine market. Most are run by banks, but two are managed by the exchange itself. Mutual funds were first organized in Argentina in the 1960s. Argentine law obligated the funds to invest the great majority of their capital in stocks and only a small portion in bonds. As a result, the mutual funds market is not a very deep or liquid market.

U.S. Presence in the Market

Of the four foreign brokerage houses in Argentina three are from the U.S. (the other is from the U.K.). In 1971, Merrill Lynch was the first large international broker to establish a branch in Argentina. It was followed by Shearson Lehman and Prudential-Bache, which also established branches. All three firms have ties to the Buenos Aires Stock Exchange through individuals, who have senior positions in the local firms. According to press reports, Prudential-Bache has devoted its activities to servicing the small investor, while Merrill Lynch and Shearson Lehman cater more to institutional investors. As of June 30, 1990, four other U.S. brokerage houses had agents in Argentina: Bear Stearns, Dean Witter, Kidder Peabody, and Salomon Brothers.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no laws that specifically discriminate against foreign firm participation in the Argentine securities markets, and U.S. firms appear to receive national treatment.

While all members of the exchanges are Argentine nationals, there are no legal barriers to foreigners buying a seat and becoming a member. Nevertheless, the thin, low-volume market in an uncertain economic environment has provoked little interest among foreign brokerage firms.

Argentine and foreign banks have expressed an interest in becoming formal members of the Buenos Aires Stock Exchange. Both domestic and foreign banks are currently blocked from obtaining a seat by the requirement that all seats be owned by individuals. Officials at the CNV say that removing such a restriction would be in line with the Menem administration’s policy of opening the domestic economy to greater competition. Should the stock market allow firms to become members, subsidiaries of some U.S. banks could seek membership.

CONCLUSION

There is no legal discrimination but U.S. firms have expressed little interest. There are no laws that specifically discriminate against foreign firm participation in the Argentine securities markets and U.S. firms appear to receive national treatment. However, the thin, low-volume market in an uncertain economic environment has resulted in little investor interest among foreign brokerage firms.

5. Brazil - Banking

SUMMARY

Brazil has imposed a ban on foreign entry in the financial sector, pursuant to transitional provisions in the 1988 Constitution. The operations of previously established foreign banks -- including three U.S. banks -- have been grandfathered under the law.

It is impossible to predict when the ban on new foreign bank entry will be lifted. The Congress can remove the limitation by passing a new law on the role of foreign capital in the financial sector, although it is uncertain whether new legislation will result in better treatment of foreign banks.

Grandfathered U.S. financial institutions in the Brazilian market may not act as the Government of Brazil's (GOB) agent to collect taxes and fees. Otherwise, they generally receive national treatment.

Treatment of foreign banks has regressed with respect to new entry. A significant new denial of national treatment has been erected, and an old one continues, although Brazilian authorities have recently undertaken some administrative actions that may permit domestic and foreign banks to broaden their activities.

As of year-end 1989, three U.S. banks operated 41 branches with assets of $3.3 billion and 38 subsidiaries with assets of $3.3 billion in Brazil. This presence is roughly comparable to the U.S. presence at year-end 1985. At that time, two U.S. banks had 22 branches in Brazil with total assets of $3.4 billion. U.S. banking corporations reported a controlling interest in 43 subsidiaries of affiliates in Brazil with total assets of approximately $3 billion, one of which was a wholly owned full service commercial bank with 40 branches and $600 million in assets. An additional 42 U.S. banks operated a total of 49 representative offices there.

At the end of 1989, 15 Brazilian banks operated eight agencies with assets of $1.8 billion, 16 branches with assets of $2.5 billion, and one subsidiary with assets of $407 million in the United States. Brazilian banks or individuals also controlled two Edge Act Corporations with total assets of $9.8 million. Brazilian banks maintain six representative offices in the United States. This presence represents a decrease of one branch, one agency and three subsidiaries, amounting to $1.8 billion in assets, since year-end 1985. At that time, 17 Brazilian banks operated 26 commercial banking offices in the United States (17 branches and nine agencies) with total assets of $6.5 billion and maintained three representative offices. Brazilian individuals also reported majority ownership in four U.S. banks with a total of 36 branches and aggregate U.S. assets of $7.4 billion. Majority ownership by Brazilian-owned interests was also reported for three Edge Act Corporations. One additional Brazilian bank operated a representative office in the United States.

OVERVIEW

Domestic Banking Market

Over the past two decades, Brazil's financial services sector has grown at a faster pace than the economy as a whole. The sector made up nearly 15 percent of gross domestic product in 1988. The entire financial services sector is roughly one-third of the size of the combined manufacturing sector and has generated profits at more than twice the average corporate level.

Commercial banks dominate the Brazilian financial system. As of June 30, 1989, they held 70 percent of total assets in the financial system.

Total Assets ($Billions)

As of June 30, 1989, at the then-prevailing exchange rate:

Private Commercial Banks	97.1
State Commercial banks	95.1
Development Banks	26.1
Investment Banks	12.7
Stock Brokers (1)	11.3
Stock Distributors (2)	12.5
Real Estate Finance	10.3
State Savings Bank	6.5
Finance Companies	2.0
Total	273.6

(1) Firms holding a seat on Rio de Janeiro or Sao Paulo exchanges.

(2) Firms not holding seats, which trade indirectly via brokers.

The Banco do Brasil performed many Central Bank functions prior to the establishment of the Banco Central do Brasil as the Central Bank. The Banco do Brasil continues to devote a large share of its lending to government agencies and acts as the Government's agent in many transactions.

Until recently, the financial system was highly segmented in theory if not in practice between commercial banks, investment banks, brokerage houses, and other nonbank financial institutions. In September 1988, however, the Central Bank allowed some banks to broaden their activities through the creation of "multiple banks."

The multiple bank is essentially an all-service bank. Under Central Bank rules, a bank can qualify to receive multiple portfolios, and thereby offer commercial banking services, as well as leasing, brokerage or investment banking services. The Brazilian Central Bank grants these separate portfolios upon being satisfied with the applicant's capital adequacy and the "appropriateness" of the applicant's standing.

Over 70 multiple banks have been authorized, approximately 20 percent of which have foreign ownership. Four multiple banks are at least partly U.S.-owned. While these banks welcomed the liberalization, it is too early to judge if this is part of a wider trend. Despite criticism of the multiple-bank "opening" as inconsistent with the constitutional freeze on expanding the role of foreign capital, there have been no court challenges.

U.S. Presence in the Market

There are four U.S. banks with operations in Brazil. Bank of Boston and Citicorp have branches with full commercial banking privileges and Chase Manhattan owns 99.9 percent of a local commercial bank. J.P. Morgan acquired the branches and assets, as well as grandfathered privileges, of Banca Commerciale Italiana in 1988. At the end of 1989, U.S.-owned banks controlled roughly 6.7 percent of private commercial banking assets in Brazil.

Nineteen of the commercial banks in Brazil were wholly owned and ten were partially owned by foreigners at the end of 1987. Besides the U.S., foreign banks represented Argentina, Belgium, Germany, Italy, the Netherlands, Portugal, Spain, the United Kingdom and Uruguay.[1]

Prior to the existence of Brazil's Central Bank, Bank of Boston and Citibank entered as branches of their U.S. parent banks, with full commercial bank rights. They still retain this branch status as a grandfathered privilege, although post-World War II applicants were not permitted to enter as branches.

Subsequent U.S. entrants came to Brazil under rules which changed over time and which were not always administered transparently. Despite rules established in 1964 restricting foreign entry to purchase of minority participation in existing commercial banks, a means favored by the GOB of injecting fresh capital into financially weak banks, Chase Manhattan was allowed to purchase a 99.9 percent share in a domestic bank.

Rules passed in 1968 denied new entrants the right to buy into Brazilian commercial banks, but allowed U.S. and other foreign investment in new, joint-venture investment banks. Some foreign financial institutions remain in these joint ventures through grandfathering. Some new opportunities for an expanded role for these firms may be opening.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

As noted previously, *de novo* entry by U.S. and other foreign banks is temporarily blocked by provisions of the 1988 Constitution. The Executive Branch is authorized to grant exemptions to the constitutional provision on "national interest" grounds, but has not indicated any plans to do so.

The first such provision calls for the Congress to pass legislation to regulate the role of foreign capital in the Brazilian financial sector. The second provision applies a freeze on any new foreign investment in the financial sector, until such time as the Brazilian Congress enacts such legislation. Since the Congress has not yet acted on this legislation, the "temporary" freeze remains a barrier to foreign entry in banking and securities.

Grandfathered U.S. and other foreign banks may not act as an agent for the Government in the collection of taxes. Domestic banks benefit from a short-term float in handling these payments for the Government.

Both foreign and domestic banks are subject to restrictions on branching. These restrictions affect foreign banks more severely than domestic banks, since domestic banks may add branches by acquiring other banks.

The President has recently granted branches of foreign banks (rather than foreign-owned subsidiaries) permission to acquire additional branches with the authorization of the Central Bank. The Central Bank has not indicated the number nor the time frame in which any new branches, if requested, will be authorized.

CONCLUSION

The treatment of foreign banks has regressed with respect to new entry. A significant new denial of national treatment has been erected and an old one continues, although Brazilian authorities have recently undertaken some administrative actions that may permit domestic and foreign banks to broaden their activities. Pursuant to provisions in Brazil's 1988 Constitution, Brazil has a *de facto* ban on the right of entry of foreign banks as new branches or subsidiaries. The prohibition remains in effect unless new laws are promulgated authorizing entry of foreign banking institutions. Those foreign banks already established in Brazil (of which three are U.S. banks) are prohibited from acting as the Government's agent for collection of taxes and fees.

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[1] Pedro Bodin de Moraes, "Foreign Banks in the Brazilian Economy in the 1980s," United Nations Economic Commission for Latin America and the Caribbean, 31 December 1989, p. 3-4.

6. Brazil - Securities

SUMMARY

Brazil's securities markets function under the regulatory supervision of the Securities Commission, the equivalent of the U.S. Securities and Exchange Commission (SEC). Unlike the U.S., Brazil has not established rigid distinctions between banking and securities operations. U.S. and other foreign firms established in Brazil are active in the securities sector and some have attained high performance rankings within the industry. Banks such as Chase Manhattan and Citibank have been particularly visible and successful performers. Nevertheless, 1988 Brazilian constitutional strictures prohibit the entry of new U.S. banks and securities firms. U.S. firms established in Brazil prior to the Constitution have grandfathered rights.

As a result, significant denials of national treatment, both new and old, exist.

OVERVIEW

Domestic Securities Markets

Brazil's National Monetary Council is the highest federal government regulatory body which oversees Brazil's stock and debenture exchanges and securities brokerage houses. This council is formally chaired by the Federal Economics Minister and is composed of a mix of cabinet-level appointees in the economic area, the heads of federal agencies in the financial area and nine private-sector appointees (largely from the banking world). The council supervises the securities industry via the Securities Commission (CVM), a regulatory body linked to the Economic Ministry, in accord with legislation dating from 1976.

The CVM, Brazil's equivalent of the U.S. SEC, is administered by a president and four directors -- all presidential appointees. The relevant 1976 legislation (Law 6385) specifically empowers the commission to supervise the activities and services of the securities market and impose fines to punish infractions. Before stock exchanges in Brazil can start operations, prior authorization from the Securities Commission is required.

Brazil has nine stock exchanges. These consist of Brazil's two main securities exchanges, located in Rio de Janeiro and Sao Paulo. (The Rio exchange is officially known as the Rio de Janeiro or IBV; the Sao Paulo Stock Exchange has the formal name of Bolsa de Valores do Estado do Sao Paulo, Bovespa.) There are relatively minor stock exchanges in the cities/states of Porto Alegre, Parana, Santos, Bahia, Pernambuco and Ceara, as well as the combined Minas Gerais, Espirito Santo and Brasilia exchange (located in Belo Horizonte City). Daily volume of operations on these exchanges provides a rough comparison of the relative size of these markets.

Turnover on June 5, 1990 ($ calculated at the prevailing exchange rate used for most import-export transactions):

Sao Paulo	11,292,866
Rio de Janeiro	4,090,237
Minas, E.S., Brasilia	111,315
Porto Alegre	72,580
Parana	55,860
Santos	36
Bahia	42
Pernambuco	0
Ceara	0

Combined secondary market turnover on all the exchanges amounted to approximately $18 billion in 1988. Roughly $523 million was raised through stock flotations in the primary market in 1988. Brazil has a separate futures market in Sao Paulo, the Bolsa Mercantil e de Futuros -- originally founded by the Sao Paulo Stock Exchange and main exchange members in that market. It is estimated that over 80 percent of Brazil's futures trading activities is concentrated in this single futures market. It serves as a futures market for future financial assets (including gold and national Treasury bonds).

Market Participants: Brazil has two classes of "stockbrokers" - - corretoras and distribuidoras. Corretoras are firms that actually hold seats on exchanges. Distribuidoras (stock distributors) do not own seats, but accept buy/sell orders from investors and must deal indirectly with the exchanges via firms which hold seats on exchanges. Although both classes are referred to as stockbrokers by local investors, legally distribuidoras are not stockbrokers, since a seat on an exchange must be purchased in order to establish a brokerage firm.

Both foreign and domestic firms may function as either class, since legally, any firm already established in Brazil may purchase a seat on an exchange. Some U.S. firms, including Citibank (as of end-1989), have established both. The Central Bank and the Securities Commission limit the number of seats allowed on each exchange in Brazil. The value of a seat on the Sao Paulo Exchange is about $500,000. The Central Bank must grant authorization to both distribuidoras and corretoras to carry out operations. Brazil has over 170 actively functioning corretoras and over 270 distribuidoras. Out of a total of 246 brokerage houses in Brazil, only five have direct foreign investment. Twenty others have indirect foreign investment through holding companies.

The following two tables list the top 10 brokerage firms in terms of year-end 1989 net worth and net profit. These firms are broken into the two distinct categories, corretoras and distribuidoras.

Top Ten Corretoras

	Firm	Worth ($millions)	Profit ($thousands)	Owner
1.	Banespa	202.9	79,159	Brazilian
2.	Banestado	44.7	17,816	Brazilian
3.	PEBB	42.6	79	Brazilian
4.	PANEB	15.5	11,564	Brazilian
5.	Planibank	14.2	66	Brazilian
6.	Crefisul	11.9	933	U.S.
7.	Sogeral	10.3	541	French
8.	Garantia	10.2	981	Brazilian
9.	Bradesco	10.2	1,062	Brazilian
10.	BFB	9.2	4,328	French

Top Ten Distribuidoras

	Firm	Worth ($millions)	Profit ($thousands)	Owner
1.	Banco Brasil	62.3	19,688	Brazilian
2.	Roma	22.1	2,893	Italian
3.	Gartra	17.2	2,238	Brazilian
4.	Montreal	16.9	2,127	U.S.-Canadian
5.	Bozano S.	16.1	-292	Brazilian
6.	Citibank	15.0	8,120	U.S.
7.	Divergs	13.9	513	Brazilian
8.	Creditans	13.4	4,235	FRG
9.	Diminias	3.3	955	Brazilian
10.	Progresso	9.9	4,396	Brazilian

A more broadly based measure of performance is a mix of ratios which include (1) annual increase in assets, (2) return on assets, (3) real revenue growth, (4) operational profit and (5) operational turnover. This abstract measure was calculated for top corretoras and distribuidoras by combining into a single "overall performance" index/rank order the relative ranking of key securities firms in the above five different measures. The "overall performance" indexes were calculated by assigning a specific securities firm 10 points for each of the five ratios/measures in which that firm was the top performer among all securities traders, nine points for ranking second, eight for ranking third, etc. By adding the individual scores in the five categories, the "overall performance" ratio is calculated. The following tables show the top rankings:

Ten Best Performing Corretoras

	Firm	Score	Owner
1.	Baneb	39 points	Brazilian
2.	BMC	29	Brazilian
3.	Banestado	29	Brazilian
4.	Banespa	27	Brazilian
5.	BFB	21	French
6.	Grande Rio	20	Brazilian
7.	BMD	19	Brazilian
8.	Augusta	19	Brazilian
9.	PEBB	19	Brazilian
10.	Banrisul	17	Brazilian

Ten Best Distribuidoras

	Firm	Score	Owner
1.	Banco Brazil	40 points	Brazilian
2.	Creditanstalt	29	FRG
3.	VR	27	Brazilian
4.	Chase Manhattan	26	U.S.
5.	Citibank	22	U.S.
6.	Progresso	20	Brazilian
7.	Diminas	19	Brazilian
8.	Fiat	18	Italian
9.	Gartra	18	Brazilian
10.	Dibahia	17	Brazilian

Market Share of Market Participants: Recent data for the Sao Paulo Stock Exchange show the following approximate investor participation in common and preferred stocks and debentures. Individual investors held approximately 29 percent of the total traded. Commercial banks (who may actively trade in stocks in Brazil's deregulated environment), investment companies and distributor companies held approximately 23 percent, public and private corporations held 22 percent, with the remainder falling in the "other" category. Given the high and unpredictable inflation trends in Brazil -- and a consequent short-term mentality on the part of both institutional investors and individuals -- the medium- to long-term corporate bond market is not significant in Brazil.

U.S. Presence in the Market

The Government Paper Market: Sustained Government deficit spending over recent years has resulted in a large supply of government paper in the hands of the private sector. These instruments represent an important vehicle in the domestic securities market. They have proven attractive to private investors -- both to individuals and corporations -- since this market has generally offered high liquidity as well as positive real returns (in a highly inflationary environment). Investors trade in the government securities market by buying and selling participations via wholesale dealers who are certified by the Government to participate in the Brazilian Central Bank's primary government paper market. Most of these certified dealers are Brazil's largest foreign and domestic commercial banks. The most important federal domestic debt instruments are financial letters of the Treasury (LFTs), letters of the National Treasury (LTNs), and obligations of the National Treasury (OTNs). These instruments are distinguished from each other by maturity term and the method by which exchange rate correction and inflationary indexing is computed.

Stocks of Government Paper (end-1989 $millions)

Instrument	Value of Stock Outstanding
LFT Paper	$118,841.3
LTN Paper	14,712.1
BTN Paper	1,223.8
OTN Paper	281.7
Total (NCz$1,534.0 bil)	$135,058.9 mil

Other securities market instruments (which cannot be strictly segregated from banking-sector activities in a regulatory environment which does not clearly demarcate along the lines of the traditional Glass-Steagall law in the U.S.) include the following:

Mutual Funds (Fundos Mutuos de Acoes): Mutual funds are structured similarly to the U.S. equivalent, but are often operated by the largest banks. There are nearly 100 mutual funds in Brazil. Customers buy into these funds by dealing directly with the operating firm. Foreign banks established in Brazil are operators of mutual funds, and would-be investors can purchase shares from bank offices. (Among U.S. banking institutions, Chase operates two mutual funds and Citibank and Norchem each operate one -- French and British banks are also active.)

Fixed-Income Mutual Funds (Fundos Mutuos de Renda Fixa): Fixed-income mutual funds place their funds mainly into certificates of deposits and debentures. There are 149 such funds, managed mainly by Brazil's largest banks. Investors purchase shares in these funds directly from the operating bank (often by phone). Foreign banks are active in offering this investment vehicle to their customers (including Chase, Citibank, Bank of Boston, Norchem and Continental, as well as French and British banks).

Short-Term Government Paper Funds (Fundos de Aplicacoes de Curto Prazo): Short-term government paper funds in Brazil number roughly 160. They are offered to the public by major banks which sell shares directly to investors (often by phone) without intermediaries. Foreign-owned banks are active in managing these funds which place their capital in LFT and OTN government instruments. (Banks active in this area include Chase, Citibank, and Bank of Boston, as well as British, French and Japanese banks.)

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The same rules that exist for banks apply to securities firms. Most securities firms are also organized as "multipurpose banks" and many banks own securities firms, as permitted under regulations issued in 1988. A 1964 law (No. 4131) required that all financial institutions in Brazil be under majority Brazilian national control. Central Bank Resolution 922 of May 1984, states that administrators of brokerage firms must be natural persons resident in Brazil who meet the conditions of relevant legislation. The 1988 Constitution required the Congress to pass legislation to regulate the role of foreign capital in the financial sector. In the absence of such legislation, a freeze on new investment has been in effect. The Constitution provides one exception, that of institutions that enter pursuant to a negotiated reciprocal agreement with another country.

Recent foreign entrants to the securities market were able to file initial documentation with the Central Bank prior to the October 1988 promulgation date of the Constitution. A draft law to implement constitutional provisions is reportedly pending in the Congress. When it is passed, foreign firms again will be able to enter the Brazilian market. The law is expected to continue, however, restrictions on majority ownership by foreign firms.

Currently, a foreign firm may not hold more than one-third of the voting shares and not more than half of the total shares of a financial institution in Brazil. Grandfathered firms are exempt from these limitations. Temporary exceptions have been granted to several other foreign banks and other financial firms, which have been given a specific time to regularize their situation. Most of these cases stemmed from financial problems of the firms' Brazilian partners.

The requirement that Brazilians have majority control has not prevented foreign firms from entering the market. There appear to be two distinct practices: some foreign firms have entered into a joint venture with Brazilian partners, who themselves put up the required two-thirds capital and share in management. In other cases, the foreign firm placed the majority shares in the name of some of its Brazilian employees or directors who were loaned the money for their share of the capital. Side letters indicated the nature of the transaction and linked control to the foreign entity. These side letters have no legal status in Brazil, however.

Market participants complain of frequent changes in rules and regulations, stating that sudden and continual rule changes create confusion and disrupt the market. The Central Bank and CVM have substantial power to act in the absence of comprehensive or clear regulatory legislation.

There is, however, no evidence rule shifts have discriminated against foreign firms. U.S. and foreign securities firms already established in Brazil generally appear to be operating successfully -- particularly those which function as distribuidoras.

Nevertheless, and more importantly, however, new foreign firms in the securities industry face a _de facto_ ban on _de novo_ entry as a result of Brazil's 1988 Constitution, which closed the door on new entry. The new Collor Government, however, appears to want to encourage more activity by foreign securities firms in Brazil.

CONCLUSION

Regression: a significant new denial of national treatment has been erected and old ones continue. Foreign firms seeking to invest in Brazil's securities markets face a _de facto_ ban on new entry based on provisions in Brazil's 1988 Constitution. The ban on new establishment may be modified or lifted by Congressional legislation. In addition, limits on foreign capital participation continue. Established foreign financial firms (e.g., Citibank and Chase Manhattan) are very active in securities trading and other financial services.

7. Canada - Banking

SUMMARY

The regulatory environment of the banking sector in Canada has improved significantly for U.S. firms since the 1986 National Treatment Study Update. Parallel actions by the Federal Government and the provincial government of Ontario in mid-1987 permitted banks to enter the securities industry through the creation of securities subsidiaries. In January 1989, the U.S.-Canada Free Trade Agreement (FTA) went into effect. The FTA includes a chapter on financial services, in which the Government of Canada agreed to exempt U.S. bank subsidiaries from limitations imposed in 1980 on the assets, branches and transfers of loans to the parents of foreign bank subsidiaries. In May 1989, the Bank of Canada approved the applications of several U.S. banks to become primary distributors of Government of Canada medium- and long-term debt instruments.

The most significant remaining barrier to equality of competitive opportunity for U.S. banks in Canada is the requirement that all foreign banks may do business in Canada only as a Canadian incorporated subsidiary of the parent. Given the implicit nonrecognition of the parent's capital, prudential lending limits that restrict loans to any one borrower relative to the foreign subsidiaries' own capital adversely affect their ability to compete in lending to the corporate sector. Also related to the mandated subsidiary status is a requirement that at least 50 percent of the directors of the subsidiary be Canadian citizens. Finally, U.S. bank subsidiaries remain subject to the requirements that all banks must maintain and process in Canada information and data related to their business and that such data processing must be limited to their banking activities. (Similar data processing restrictions apply to Canadian banks.)

The banking sector in Canada is regulated exclusively by the Federal Government. In 1987, the Government adopted several measures to alter the structure and functions of the regulatory authorities. It increased the responsibilities and the capacity of the Canada Deposit Insurance Corporation (CDIC), which provides deposit insurance for all deposit-taking institutions. It consolidated the Inspector General of Banks and Superintendent of Insurance under an Office of the Superintendent of Financial Institutions (OSFI). Also in 1987 the Government amended the Bank Act to remove the prohibition of bank involvement in securities activities. The federal authorities subsequently instituted review and clearance of applications from foreign firms and all banks to establish securities subsidiaries. In 1988, the Superintendent concluded agreements with the Securities Commissions of Ontario, Quebec and British Columbia to facilitate exchange of information and define respective regulatory jurisdictions and responsibilities.

On September 27, 1990, the Government formally introduced a package of legislative proposals for financial regulatory reform designed to facilitate the integration and growth of the financial services industry. The proposals are based on the Government's 1986 paper entitled "New Directions for the Financial Sector." They would extend the powers and activities of various institutions and allow common ownership of firms within the financial sector. The reform package opposes the growth of links between commercial and financial firms and proposes that Schedule I banks have 100 percent and large (capital exceeding C$ 750 million) federal trust and loan companies have 35 percent of their voting shares publicly traded and widely held. The legislative proposals for reform were announced concurrently with the tabling of the new federal Trust and Loan Companies Act by the Government. The proposed law is to serve as a model for subsequent amendments to federal statutes governing banks, insurance companies and cooperative credit associations.

Canada's banking sector at the beginning of 1990 consisted of 65 banks, of which eight were Canadian-owned and 57 were the subsidiaries of foreign banks. The domestic banks dominated the sector, with approximately 90 percent of total bank assets.

The U.S. and Canadian authorities met periodically in 1990 to both review the implementation of their respective commitments under the financial services segment of the FTA and to discuss the evolution of financial services in Canada and the U.S. There has been significant improvement in Ontario and in Federal review of application for entry and removal of most barriers to right of establishment and operations, except that no branching is permitted.

As of year-end 1989, U.S. banks operated 20 subsidiaries with assets of $14.7 billion in Canada. Among nonbank deposit-taking institutions, there were three relatively small trust and loan companies and four large finance or acceptance companies owned by U.S. companies. In contrast, U.S. banks operated 17 subsidiaries and four representative offices with assets of $8.4 billion in Canada as of end-year 1985.

At the end of 1989, seven Canadian banks operated 16 agencies with assets of $4.6 billion, 14 branches with assets of $22.2 billion, and 21 subsidiaries with assets of $12.5 billion in the United States. Canadian banks or individuals also controlled an Edge corporation with assets of $184 million. Canadian banks maintain 35 representative offices in the United States. As of end-1985, Canadian banks operated 20 subsidiaries, 18 branches, 11 agencies, 32 representative offices and one Edge Act office in the United States.

OVERVIEW

Domestic Banking Market

At the beginning of 1990, there were 65 banks in Canada, with total assets of C$ 532 billion ($453.7 billion). The Canadian banking industry prospered in recent years and total assets increased by about C$ 95 billion (22 percent) since the end of 1985. The period also was characterized by consolidation, as the number of Canadian chartered banks declined from 14 in 1985 to eight in 1990, thus reducing the total number of banks by six. There was no net change in the number of foreign banks, which remained at 57.

The eight domestic banks remaining in 1990 included: five with assets in excess of C$ 60 billion ($51.2 billion) each; one with assets of about C$ 35 billion ($29.8 billion); and two with assets of less than C$ 6 billion ($5.1 billion). One medium-sized bank was wholly owned by a financial conglomerate; the other seven domestic banks were widely held in accordance with federal law, with no one owner holding more than 10 percent of the voting shares. The domestic banks continued to dominate the banking industry, in spite of a modest decline in their share of total bank assets from 93.6 percent in late 1985 to 89.8 percent in late 1989. Their combined total of branches and offices nationwide increased from 7,000 in 1985 to 7,300 in 1989.

The total assets of foreign banks in Canada at the end of 1989 amounted to C$ 54 billion ($46.6 billion), which represented an increase in their share of total assets of the Canadian banking system from 6.4 percent in late 1985 to 10.2 percent in late 1989. While the number of foreign banks' subsidiaries remained unchanged at 57, the total number of branches and offices increased from 220 to 296 due mainly to the acquisition of two small Canadian banks by two foreign (non-U.S.) banks.

Owing to closings, consolidations and new entries, the composition of foreign banks in Canada changed. The number of U.S. banks declined by three to 20; there were two fewer U.K. banks at four. On the other hand, the number of subsidiaries of Japanese banks increased by seven to 10; there also was a net increase of one bank from other Pacific Basin countries. All of the foreign banks are wholly owned by their parents; however, a British bank subsidiary announced in 1990 that it plans to sell up to 25 percent of its shares to the public. In early 1990, Hongkong Bank of Canada, the largest foreign bank in Canada, announced the acquisition of Lloyds Bank Canada (the third largest). Their combined assets amounted to C$ 10.7 billion ($9.1 billion), making the expanded Hongkong Bank the seventh largest bank in Canada with 125 branches and offices. The next largest foreign bank was Citibank, with assets of C$ 5.3 billion ($4.5 billion). Including Hongkong Bank and Citibank, the 10 largest foreign banks reflected a broad geographic distribution with one bank from Hongkong, three banks from Switzerland, and two banks each from the U.S., the U.K. and France.

Operations and Functions of Banks in Canada: The large Canadian banks operate extensively abroad as well as throughout the 10 provinces and two territories of Canada. They offer a broad range of retail and wholesale banking services. They account for an estimated 75 percent of deposits and about 85 percent of outstanding commercial loans. In addition, by means of specialized nonbank subsidiaries, they operate in real estate financing, leasing, and factoring. They are not permitted to engage in fiduciary activities or automobile leasing. They all are direct participants in the capital markets, although some banks are transferring certain capital market responsibilities to their newly created securities subsidiaries.

Many foreign bank subsidiaries in Canada concentrate on wholesale banking, capital markets and lending to the corporate sector. However, a number of the foreign banks engage in retail banking among selected immigrant populations. Hongkong Bank has a nationwide network of 120 branches, as the result of its acquisition in 1986 of the Bank of British Columbia and in 1990 of Lloyds Bank (which previously took over Continental Bank of Canada). Many foreign bank subsidiaries have expanded beyond traditional commercial banking functions. Some are among the leading bond traders in Canada; others are active in mortgage loans and leasing.

A number of nonbanks in Canada compete for the deposits and business of the banks. They include trust and mortgage companies, credit unions (including the Caisses Populaires in Quebec), sales finance companies, and several public sector savings and financial agencies. Other financial institutions include consumer loan companies, life and health insurance companies, property and casualty insurance companies, investment or securities dealers and several merchant banking institutions. The nonbanks and other financial institutions are subject to either general or provincial regulatory jurisdictions. A few of the larger nonbank firms operate throughout the country, while many are small and found only in certain regions. None are subject to the Bank Act, the banking guidelines of the Superintendent for Financial Institutions or the banking requirements of the Bank of Canada.

Electronic clearing in the Canadian banking system is transacted through the Canadian payments system, which is governed by the Canadian Payments Association Act. The Payments Association is chaired by officers of the Bank of Canada and has representatives of the banks and other institutions on its board of directors. The number of automated teller machines (ATM) increased from 1,500 in 1985 to an estimated 7,366 in May 1990. These ATMs include those participating in two U.S.-owned systems with links worldwide, Cirrus System, Inc. and Plus System.

The dominant ATM network in Canada is a Canadian-owned system, Interac. The Canadian Payments Association Act and the Bank Act permit only cash withdrawals via ATM transactions, and require that transactions between member institutions in Canada of any of the three systems be routed and settled entirely within Canada.

Major Regulatory Developments Since 1986: The Federal Government adopted legislation in mid-1987 that made three major changes in the regulation of banks and their permitted activities. In follow-up to the failure of two banks in 1985 and legislation in 1986 to strengthen the Canada Deposit Insurance Corporation (CDIC), the legislation in 1987 further provided for the CDIC to remain separate from the federal supervisory authorities. This permitted the CDIC to expand private sector expertise on its board of directors and to preserve its established relationship with provincial authorities supervising provincially regulated institutions insured by the CDIC. The legislation also enhanced the CDIC's discretion to issue deposit insurance coverage, clarified its power to initiate a process for termination of coverage and provided for higher CDIC premiums and surcharges.

The 1987 measures also consolidated the Office of the Inspector General of Banks and the Department of Insurance under a new Office of the Superintendent of Financial Institutions (OSFI). The new Superintendent, appointed by the Minister of Finance, was given full supervisory responsibilities for banks and federally regulated nonbank financial institutions (e.g., most large trust and loan companies, insurance companies and cooperative credit associations). The legislation increased supervisory powers, created a private sector advisory committee to assist the Superintendent and established a coordinating committee consisting of CDIC, OSFI, the Bank of Canada and the Department of Finance. A superintendent and three deputies were appointed and their staff was increased.

The third and most significant development was parallel actions by the Federal Government and the province of Ontario to permit banks to enter the securities business by owning securities subsidiaries. This expansion of powers went into effect June 30, 1987. The federal authorities and the Ontario authorities worked out a tentative agreement on the distribution of regulatory responsibilities regarding the banks and their new subsidiaries. This accord was expanded and refined in 1988 and extended to other provinces.

During the 12 months from mid-1987 to mid-1988, five of the six largest Canadian banks acquired control of major Canadian investment dealers. The other bank chose to build from within by expanding its existing discount brokerage staff and operations. By 1990, several foreign banks also had created securities subsidiaries or had acquired control of Canadian securities dealers. In most cases, the banks permitted their acquired dealers to continue to operate largely independently.

However, one large Canadian bank that acquired a large dealer, and those domestic and foreign banks that chose to create their own subsidiaries, became more directly involved in the securities business.

Further Financial Regulatory Reform: On September 27, 1990 the Government formally announced its proposals for reform of financial institutions legislation. The announcement was made in conjunction with the tabling of the proposed federal Trust and Loan Company Act. The act aims at updating the statute governing the trust and loan industries and provides the model for proposed subsequent changes in the laws related to banks, insurance companies and cooperative credit associations. Together, this act and the overview of legislative proposals for reform of federal financial institutions constitute a major reform of the permitted structure and activities of financial institutions in Canada.

Various financial institutions and their associations supported the main objectives of the proposed reforms: to expand the powers and functions of financial institutions; to establish new rules governing ownership and capitalization; and to strengthen regulatory controls and prudential safeguards.

The proposed measures would permit increased consumer and commercial lending by trust and loan companies and the marketing of various goods and services by issuers of credit cards. The new legislation would permit networking of financial services, with the exception of insurance retailing on the premises of deposit-taking institutions. The separate but parallel bills for the different types of institutions would permit financial institutions to become affiliated, either as parents and subsidiaries or under a common holding company. The proposals would require that large firms have at least a portion of their shares publicly held (35 percent for trust and loan companies with more than C$ 750 million in capital, and 100 percent for Schedule I banks), and they would prohibit growth of links between financial and commercial companies. Finally, the reforms include measures to strengthen controls on self-dealing and conflicts of interest, including detailed provisions governing practices and procedures involving "related parties."

These reforms are consistent with the earlier steps to strengthen regulatory and prudential safeguards and to remove barriers to the ownership of investment or securities dealers. They also reflect the evolution of both operations and ownership relationships in the Canadian financial sector, where a pattern had already emerged involving alliances of the banks with the securities firms, and of life and health insurance companies with trust and loan companies.

U.S. Presence in the Market

There were 20 U.S. bank subsidiaries in Canada in early 1990, three fewer than four years earlier but still more than from any other country. With the exception of Security Pacific Bank Canada, which is based in Vancouver, all of the U.S. banks had their headquarters in Toronto and, in addition, a total of 35 branches and other offices in Toronto and elsewhere. Among the U.S. bank offices there were also subsidiaries for specialized activities such as mortgage lending and leasing. Four U.S. banks had securities subsidiaries, all of which received regulatory approval and were established in 1988-89. In addition, one U.S. bank owned slightly less than 50 percent of a leading Canadian investment dealer.

At year-end 1989, U.S. bank subsidiaries had about $14.7 billion in total assets, which accounted for 3.2 percent of total banking assets in Canada. This represented slightly more than the U.S. share of total assets in late 1985 (2.6 percent). There were three U.S. banks among the top 10 foreign banks. One U.S. bank was the second largest foreign bank and essentially tied with a Canadian bank for the ranking as eighth largest bank in Canada. While three U.S. banks closed or sold their subsidiaries in Canada in recent years, one new firm received a banking license in 1989 and its letter patent in April 1990 to begin operations in mid-1990. One other firm undertook discussions with the financial authorities in 1988-89 with a view to obtaining a banking license. It subsequently decided not to pursue those discussions and did not apply for a license.

Most U.S. bank subsidiaries in Canada concentrate on the corporate sector and capital market activities. Given their small capital base relative to their much larger Canadian competitors, they often seek to emphasize their expertise in specific off-balance sheet areas such as foreign exchange swaps, futures or options. Only one U.S. bank has more than four branches (nine branches in four cities) and even that bank has opted to concentrate on middle to upper income clients and not to develop or acquire a large network of retail branches. One other bank has several currency exchange offices.

Of the five securities subsidiaries or firms associated with U.S. banks, only the Canadian investment dealer with U.S. bank participation is engaged in full service securities business and belongs to the Canadian stock exchanges. The others belong to the Investment Dealers Association and are engaged in relatively modest corporate bond and equities underwriting but not retail securities selling.

In 1989, three U.S. banks received authorization to function as primary distributors of Canadian government securities. They were among a group of six U.S. banks and securities dealers that were the first foreign firms to be accorded such status by the Bank of Canada. They qualified by demonstrating expertise and a capacity for trading government securities in the secondary market. One of the U.S. banks is recognized as the second largest player in the government bond market in Canada. In 1989 the Canadian government approved an application for a bank license by American Express Canada (AMEX), which went into effect in July 1990.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The treatment of foreign banks in Canada, including U.S. banks, steadily improved in the 1980s. Prior to 1980, foreign banks were not permitted to operate in Canada except through representative offices and unregulated subsidiaries such as leasing companies. An amendment to the Bank Act in that year permitted the entry and establishment of foreign bank subsidiaries. However, the foreign banks were subjected to administrative controls on their growth via limited allocation of "deemed authorized capital" aimed at restricting them in aggregate to no more than 8 percent of the domestic assets of all banks. When that share of market was approached in 1984, another amendment to the Bank Act raised the ceiling to 16 percent. In 1987, the Bank Act was amended again, this time to permit all banks, domestic and foreign, to establish securities subsidiaries and/or acquire existing securities or investment dealers.

U.S. banks benefitted further from the conclusion of the U.S.-Canada Free Trade Agreement, which entered into force January 1, 1989. Under the financial services chapter of the FTA, U.S. banks were exempted from the system of deemed authorized capital and share of market limits. They also were exempted from the requirement that foreign bank subsidiaries must obtain approval of the Minister of Finance prior to opening branches within Canada. Subject to prudential requirements of general application, the U.S. bank subsidiaries also were exempted from regulatory restraints on transfers of loans to their parent companies. Finally, the 25 percent limit on aggregate foreign ownership of a widely held Canadian bank was eliminated as it pertains to U.S. banks. A 10 percent maximum for holdings by any one individual or entity applies equally to foreigners and Canadian residents and remained in place.

The various restrictions on establishment, growth, branching, transfers of loans, and investments in Canadian banks remained in effect for all non-U.S. foreign banks in Canada. In fact, in removing the U.S. banks from the calculation of the share of banks' domestic assets, the Canadians reduced the aggregate share permitted to other foreign banks from 16 percent to 12 percent.

Some problems continued to adversely affect the entry of U.S. firms desiring to establish a bank in Canada. The process of applying for and receiving a bank license in Canada often was complicated, nontransparent and prolonged. Consistent with the discredited practices of the defunct Canadian Foreign Investment Review Agency, the financial authorities required considerable information and data and demonstrations of benefits to accrue to Canada before the granting of a license. Moreover, foreign banks were subjected to making specific undertakings regarding their subsequent operations and investments.

One U.S. company's efforts to obtain bank status in Canada took nearly four years and, in accordance with Canadian law, necessitated undertakings by the firm to keep its banking functions separate from its other business activities. Even after receiving a license, authority to actually begin operations was postponed for another year. Another U.S. firm engaged in discussions with the financial authorities for nearly a year, providing considerable data and responding to extensive queries regarding its business intentions. The company finally concluded that a bank license would not be forthcoming in the foreseeable future. Based in part on that judgment, the company withdrew from further discussions without submitting a formal application. It subsequently decided to substantially curtail its commitment to doing business in Canada. A third U.S. financial company encountered resistance when it undertook to acquire full control of its subsidiary by buying out the Canadian partners. It finally received regulatory approval but only after nearly two and one-half years of negotiations and after being obliged to agree not to apply for a bank license.

The Bank Act continued to prohibit U.S. and other foreign banks from operating in Canada through a branch. It required that a foreign bank must conduct any business it does in Canada through a Canadian incorporated subsidiary of the parent bank. This situation contrasted with the right of establishment according to foreign banks in most other industrialized nations. It presented several administrative and operational problems for U.S. banks, increased their costs of doing business in Canada and adversely affected their ability to compete effectively with the large Canadian banks.

As regards the operations of U.S. banks once they are established in Canada, the improvements in recent years included eligibility to become primary distributors of Canadian government securities. This move in 1989 followed the earlier authority granted in 1987 to enter the securities business and the exemptions under the FTA from restrictions on growth, branching and transfer of loans to parent banks. In addition, the financial authorities reportedly eased their earlier demands that foreign banks concentrate a sizeable proportion of their business among medium-sized corporate borrowers.

Several of the operational problems that remained for U.S. banks in Canada were directly related to the requirement that all foreign banks must operate through a Canadian incorporated subsidiary rather than as a branch of the parent bank. One implication was that at least one-half of the directors of a U.S. bank subsidiary must be Canadian citizens.

The fact that U.S. and other foreign bank subsidiaries are subject to prudential lending limits that ignore the capital base of the parent is an impediment to competition in the corporate lending business. Specifically, they cannot extend loans to any one borrower that exceed 50 percent (100 percent in special circumstances) of the subsidiary's capital. Since capital of the subsidiaries is small compared to that of the Canadian banks, the subsidiaries were effectively precluded from competing for large loans to the corporate sector. U.S. bank subsidiaries can transfer loans to their parents but only at increased costs. They argue that the best solution would be for Canada to permit U.S. banks to establish and operate through branches, as foreign banks are permitted to do in the U.S. and most other OECD countries.

A further problem resulted from OSFI's capital adequacy requirements generally, which were more stringent than those in the U.S. and elsewhere. The burden was not connected to the provisioning requirements against lending to highly indebted developing countries. U.S. subsidiaries in Canada have very little exposure abroad. Rather, OSFI's requirements covered inter-company transactions and its definition of capital included real estate. In both instances though capital requirements were identical, U.S. and other foreign banks were placed at a disadvantage relative to Canadian banks because of their proportionately larger involvement in inter-company transactions and proportionately smaller holdings of real estate.

The Bank Act continued to require that all banks maintain and process in Canada their information and data related to preparation and maintenance of customers' records. This requirement increased the administrative and operational costs for U.S. banks, which in its absence might more efficiently consolidate the records of the Canadian subsidiaries with those of the parent bank in the U.S. Most of the U.S. subsidiaries had made the requisite capital outlays on data processing equipment. To the extent the result was excess capacity, some were interested in providing computer services to the public. However, the Bank Act also prohibited banks from providing computer services that were not directly related to their banking business.

FINANCIAL MARKET DISCUSSIONS

The U.S. undertook in the context of the U.S.-Canada free trade negotiations to gain removal of existing barriers to the entry and operations of U.S. banks in Canada. That effort was largely successful. It also provided for future consultations between the U.S. Treasury Department and the Canadian Department of Finance. The U.S. Treasury Department continues to closely monitor the treatment of U.S. banks in Canada. It is committed to using the consultative mechanism as appropriate to address possible problems and to assure that U.S. banks in Canada enjoy national treatment and competitive opportunities equal to those of their Canadian counterparts. U.S. Treasury and Canadian Ministry of Finance officials met periodically in

1990 to review the implementation of their respective commitments under the financial services segment of the free trade agreement and other issues of mutual interest. They will continue to discuss the evolution of financial services and the status of regulatory responses in both Canada and the U.S.

CONCLUSION

Significant improvement has been made in Ontario and in Federal review of applications for entry; most barriers to right of establishment and operations have been removed as a result of the U.S.-Canada Free Trade Agreement, except no branching is permitted. Canada eliminated its equivalent of the Glass-Steagall Act, opening the securities industry to banks. Consistent with the U.S.-Canada Free Trade Agreement (FTA), Canada eliminated the restrictions on establishing additional branches by U.S. bank subsidiaries, and on the ability of U.S. parent banks to transfer capital to U.S. bank subsidiaries. A significant improvement, from the viewpoint of U.S. banks, has been the removal of quantitative restrictions on the growth of assets of U.S. banks in Canada (also an FTA measure). The most important remaining constraint is the inability of U.S. banks to set up branches in Canada.

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*U.S. dollar figures calculated at the following rates:
1985: $1 = C$ 1.3975 YE
1989: $1 = C$ 1.1578 YE
1990: $1 = C$ 1.1726 (June 1, 1990)
1990: $1 = C$ 1.1714 (January avg.)

YE = Year-End

8. Canada - Securities

SUMMARY

The treatment of U.S. financial firms in Canada's securities markets improved markedly in the period following the 1986 National Treatment Study Update. In June 1987, Ontario, the province responsible for regulating the largest securities industry in Canada, removed existing barriers to entry by foreign securities firms. The initiative by Ontario, together with parallel action by the Federal Government, also permitted banks and other federally regulated financial institutions to enter the sector by establishing a securities subsidiary or acquiring a securities or investment dealer. The U.S.-Canada Free Trade Agreement that was negotiated in 1987 and became effective January 1, 1989, further provided that Canada would not use its review powers governing the entry of U.S.-controlled financial institutions in a manner inconsistent with the FTA and its emphasis on market liberalization and national treatment. Finally, in 1989, the Bank of Canada approved the applications of three new U.S. securities firms and three U.S. banks as primary distributors of Canadian government debt instruments.

By mid-year 1990, U.S. securities firms and banks interested in securities activities no longer encountered legal impediments to their establishment in Canada. While subject to several separate and sometimes different provincial regulatory jurisdictions, they generally enjoyed national treatment. They were welcomed as members of the self-regulatory organizations, the Investment Dealers Association and stock exchanges. Outstanding issues pertain to transparency and problems which could arise in the Federal Government review of new entrants and proposed diversification by resident U.S. firms. In addition, American employees have occasionally encountered problems associated with obtaining work permits and meeting immigration requirements.

Ontario's decision to permit banks and nonresident firms to enter that province's securities industry prompted the Federal Government to become involved, for the first time, in securities regulatory matters. The Federal Office of the Superintendent for Financial Institutions (OSFI), created in 1987, exercised its prerogative to review and rule on the entry of foreign securities firms as well as the proposed establishment of securities subsidiaries by both domestic and foreign banks. OSFI concluded agreements with the key securities commissions of Ontario, Quebec and British Columbia in 1988, regarding the exchange of information and the definition of respective regulatory responsibilities. In 1987, the Federal Government concluded an agreement with Ontario that defined the securities-related activities that may be carried on by a federally regulated financial institution parent company as opposed to those that must be carried on in the securities subsidiary.

Proposed amendments to Ontario's securities regulations, pending in early 1990, were aimed at enhanced investigative and enforcement powers. The amendments would enable the Ontario Securities Commission to implement a regulatory cooperation agreement which was concluded with the U.S. Securities and Exchange Commission in January 1988. Together with the Securities and Exchange Commission, the Ontario Securities Commission has proposed establishment of a Multi-jurisdictional Disclosure System (MDS) which would allow qualified issuers to distribute securities in both Canada and the U.S. on the basis of filing in the home jurisdiction only. Proposed reform of federal financial sector statutes was expected to reinforce the removal of earlier restrictions on the ownership of and investments by federally regulated firms and to introduce increased controls on related-party transactions.

The regulatory changes on right of establishment resulted in an increased number of firms, with a greatly expanded capital base, in the Canadian securities industry. The number of registered firms that are members of the self-regulatory system increased from 96 in 1985 to 118 in 1989, in part owing to the entry of new foreign firms that are members of the self-regulatory system and foreign bank securities subsidiaries. The aggregate regulatory capital of the industry nearly tripled from C$ 1.0 billion ($732.3 million)[*] to C$ 2.9 billion ($2.4 billion), mainly reflecting the infusion of capital by the large Canadian banks. The value of secondary transactions in the money, bond and equities markets approximately doubled from C$ 1.0 trillion ($754.1 billion) in 1987 to C$ 2.021 trillion ($1.642 trillion) in 1988. On the other hand, Canada's securities markets had not fully recovered from events in the world's stock markets in October 1987. The total value of new issues was C$ 34.4 billion ($29.1 billion) in 1989, or less than in 1985, due to declines in both corporate equity issues and government bond issues.

The U.S. presence in Canada's securities markets in 1985 consisted of four full-service securities firms, subject to restrictions on growth, and two representative offices active in "exempt market" activities. By 1989, there were eight full-service U.S. securities firms, three securities subsidiaries of U.S. banks and one securities firm closely associated with a U.S. bank. The regulatory capital of the registered U.S. securities firms and subsidiaries increased from an estimated C$ 60 million ($43.9 million) in 1985 to C$ 120 million ($101.4 million) in 1989. During the same period, the number of U.S. firms authorized to operate as primary distributors of Canadian government securities increased from two dealers to five dealers and three banks. This increase in the number of participants has helped to raise the U.S. role in the wholesale securities markets. Much of this activity is taking place through the International Dealer registration category, which does not require Canadian residency and Canadian operations. In contrast, U.S. presence in the retail market dropped sharply when Merrill Lynch decided, in early 1990, to sell its entire retail network of 20 branches in Canada to a Canadian investment dealer. In June 1990, Prudential-Bache made a similar move, selling its Canadian retail operations to a Canadian investment dealer.

U.S. and Canadian authorities met periodically in 1989 and 1990 to review the implementation of their commitments under the financial services segment of the FTA and to discuss the evolution of financial services in Canada and the U.S. There has been significant improvement in Ontario and in Federal review of application for entry.

OVERVIEW

Domestic Securities Markets

Traditionally, Canada has permitted capital to move freely across its borders, and foreign securities firms were largely free to establish offices and/or conduct business in Canada from "offshore." With a capital-intensive resource-based economy, Canada was and still is an importer of capital. The main regulatory restriction was the strict separation of different financial services into four major distinct functional groups of institutions: banks, regulated by the Federal Government; investment or securities dealers, regulated by the provinces; trust and loan companies and insurance companies, which are licensed and regulated by both federal and provincial governments.

Both jurisdictions responded to Canadian nationalists' concerns about increased activities of foreign financial institutions in the 1960s. The Bank Act of 1967 explicitly excluded foreign banks and precluded nonresidents from gaining control of domestic banks. The province of Ontario similarly adopted legislation in 1971 that blocked the entry of foreign securities firms. Approximately 26 foreign firms were grandfathered, but in 1974, they were subjected to restraints on their growth. In 1973, Quebec reversed the trend by permitting nonresidents to engage in securities business, and in 1983, the QSC obliged the Montreal Exchange to accept nonresident members. However, the bulk of the financial industry had relocated from Montreal to Toronto in the 1970s because of a rising tax burden in Quebec and the perceived threat of Quebec separatism.

Most of the firms grandfathered by Ontario opted to leave Canada. By 1985-86, there were approximately 95 securities or investment dealers, of which only four were foreign firms. All four were U.S. firms and only one of them had a significant presence in the retail equities market. The other grandfathered registered firms and several unregistered foreign firms were either small retail brokers or focused primarily on private placements, other transactions with institutional investors and trading in government securities.

By the mid-1980s, Canada's protected domestic securities industry was widely perceived to be undercapitalized to meet internal financing needs and not sufficiently engaged in innovative transactions to hold its own in the increasingly competitive global markets. Proposals by selected domestic firms to attract foreign capital led to a series of studies, hearings and reports. The ultimate result was the decision, in late 1986, by the province of Ontario to permit entry into the securities markets by foreign firms and domestic financial institutions previously precluded from the industry.

The new regime went into effect in June 1987, permitting both domestic and foreign nonsecurities dealers to create securities subsidiaries. The new regulations also removed the existing restrictions on grandfathered foreign dealers. However, domestic Canadian firms were accorded a head start regarding entry through acquisition of existing investment dealers. Domestic firms could acquire 100 percent of a dealer in June 1987, while nonresidents could acquire only up to 50 percent at that time and the remainder after June 1988.

The overall result, despite ongoing consolidation and mergers was an increase in the number of registered securities firms to 118 in 1989. The number of foreign firms increased from the four grandfathered firms to a new total of 23. The five largest Canadian banks each merged with or acquired a major Canadian investment dealer or created its own securities subsidiary. Three foreign banks took minority positions in medium to small Canadian investment dealers in 1987. Two of them increased their investments in 1989, but their control of shares still remained at no more than 50 percent. Four additional foreign banks and one domestic bank created securities subsidiaries. The total capital of the securities industry increased from C$ 1.0 billion ($732 million) in 1985 to C$ 2.9 billion ($2.4 billion) in 1989. The capital of the foreign registrants in aggregate amounted to an estimated C$ 200 million ($168.9 million) in 1989, compared to about C$ 60 million ($43.9 million) in 1985.

Although the volume of trading in Canada's securities markets approximately doubled in recent years, the value of new issues dropped after the declines in stock markets worldwide in October 1987. Secondary market trading increased from C$ 1.0 trillion ($732.3 billion) in 1985 to C$ 2.0 trillion ($1.689 trillion) in 1989. Money market transactions accounted for about 69 percent of the total, down slightly over the past four years. The bond market's share increased marginally to 26 percent and the stock market's share edged down to 5 percent.

New issues peaked in 1986 at an aggregate value of C$ 32.3 billion ($23.2 billion), of which corporate issues amounted to C$ 17.7 billion ($12.7 billion) and government issues C$ 14.6 billion ($10.5 billion). New securities were being issued at an annual rate of C$ 36 billion ($27.1 billion) in 1987, but dropped sharply in the fourth quarter. The actual value of total new issues thus declined to C$ 30.8 billion ($23.2 billion) in 1987 and C$ 30.1 billion ($24.5 billion) in 1988. New issues recovered moderately in 1989 to an estimated total C$ 34.4 billion ($29.1 billion). New government issues were largely unchanged at C$ 14.8 billion ($12.5 billion) in 1989, while new corporate issues recorded a net increase of approximately C$ 4 billion from 1985 to C$ 19.5 billion ($16.5 billion) in 1989. Debt instruments accounted for 70 percent of the net increase and equity issues accounted for the remainder.

Canadian capital markets were well developed by 1990 and included increasingly sophisticated financial services and products such as acceptances, short-term paper, swaps, options and futures. Securitization and private placements led the shift away from corporate reliance on bank loans. Unregistered primary distribution of securities to institutional investors grew rapidly in recent years. Private placements were estimated to have reached C$ 5.0 billion ($4.2 billion) in 1989 or the equivalent of approximately 25 percent of the total reported corporate debt and equity issues. Nonresident investment firms were active in Canada as intermediaries for nonresidents' investments in Canadian government bills and bonds and Canadian corporation's commercial paper, bonds and stocks. Selected nonresident firms also offered a variety of services to both Canadian borrowers and investors.

In spite of the substantial increase in capital of Canadian investment dealers in recent years, the securities industry remained the smallest of the four traditional segments of the financial sector. In 1989, the securities industry had aggregate capital of C$ 2.9 billion ($2.4 billion) and assets of C$ 17.8 billion ($15.0 billion), compared to assets of C$ 532 billion ($449.3 billion) of the banks, an estimated C$ 110 billion ($92.9 billion) for trust and loan companies and an estimated C$ 130 billion ($109.8 billion) for life insurance companies. In addition, the total assets of several other categories of financial institutions surpassed those of the securities or investment dealers; trusteed pension plans, C$ 146 billion ($123.3 billion); mortgage loan companies, C$ 100 billion ($84.5 billion); credit unions, C$ 76 billion ($64.2 billion); mutual and closed-end funds, C$ 33 billion ($27.9 billion); and finance corporations, C$ 23 billion ($19.4 billion).

Ontario Securities Markets: The largest proportion of securities activity in Canada was concentrated in Toronto, and thus, subject to regulation by the province of Ontario. In 1989, the market in that province accounted for at least one-half of new public offerings, approximately 80 percent of stock market listed trading, and perhaps, up to 80 percent of money market and bond market transactions. All but a few of the registered investment dealers in Canada were active in Ontario. This included the nonresident securities firms and banks, most of whom are headquartered in Toronto.

The provincial regulator of the securities markets in Ontario is the Ontario Securities Commission (OSC). The registration and operations of securities firms are governed by the Ontario Securities Act. That statute was amended in 1987, as were related OSC regulations in 1988, in order to implement the decision to open the market to foreign and domestic financial institutions. Simultaneously, the amendments introduced universal registration and largely eliminated previous exemptions from registration for firms engaged in only specified activities that were not deemed to require monitoring and regulation. Even with universal registration, there is no system for monitoring and regulating registrants that engage only in exempt market business and conduct their business through a registration category that is not, at this time, regulated (e.g., limited market dealer, securities dealer, international dealer).

Provisions governing right of establishment and registration are found in Sections 24-32 of the Securities Act and Part V of Regulation 910. The statute requires that any person or company that trades in a security or acts as an underwriter or advisor must register with the OSC. The regulations require that a registered dealer shall be classified in one or more of the ten following categories: broker, financial intermediary dealer, international dealer, investment dealer, limited market dealer, mutual fund dealer, scholarship plan dealer, securities dealer and securities issuer. These categories represent an expansion over previous provisions to cover financial intermediaries and foreign firms. Those nonresident firms with an office and operations in Ontario are further required to become a member of at least one of the two recognized self-regulatory organizations (SRO), the Investment Dealers Association and the Toronto Stock Exchange.

The largest domestic and foreign firms were usually registered in more than one category. International dealers were permitted to operate in Ontario from "offshore" and, under the amended regulations, are permitted to trade on Ontario’s bond market broker screens. Both banks and securities firms traded call deposits, swap deposits, commercial paper and government securities in the secondary markets. Most domestic banks that acquired investment dealers continued to engage directly in money and bond market operations. Some transferred their fixed-income business to their securities arm. Most banks that acquired investment dealers had not become involved in the corporate underwriting and retail equities operations of their securities firm. Banks that created new securities subsidiaries tended to concentrate their securities business in the subsidiaries, which entered tentatively into corporate underwriting. With the exception of a Canadian bank building on its discount brokerage, banks did not attempt seriously to become involved in retail equities business.

Banks, securities firms, and trust and loan companies all were dealers in government Treasury bills in the secondary market. The largest institutions, including six foreign firms (three banks and three securities firms), were primary distributors of Federal Government bonds. Traditionally, the bulk of new government medium- and long-term issues were allocated by the Bank of Canada to Canadian banks and to the protected Canadian securities dealers. Starting in the early 1980s, the Bank of Canada, for cost considerations, progressively increased the proportion of bonds offered by auction and reduced the use of administrative allocations.

The equities market was the smallest and in some respects least robust segment of the capital markets in Canada, especially after late 1987. Nonetheless, new corporate issues slowly recovered, and the Toronto Stock Exchange (TSE) continued to dominate equities trading in Canada. Total value of TSE transactions in 1989 amounted to C$ 83.6 billion ($70.6 billion), up 23 percent from 1988 and representing 77 percent of total trades on Canadian stock exchanges. According to the TSE, this turnover value ranked the TSE third among North American stock exchanges, with 3.8 percent of the total compared to the New York Stock Exchange (81.2 percent) and the Midwest Exchange (5.2 percent). Based on volume of transactions, the TSE accounted for one-half of Canadian trading and ranked second in North America with nearly 7 percent of the total.

The Toronto Stock Exchange had 75 members by mid-year 1990, including 11 subsidiaries of foreign firms (of which, six are U.S.). The Toronto Futures Exchange, administered by TSE staff but legally distinct, had 196 members. The TSE established links in 1986 with the American and Midwest Stock Exchanges that provided for quotations and trading in interlisted Canadian stocks. However, traditional trading practices in exchanges on both sides of the border apparently discouraged northbound orders from U.S. traders. In 1989, these links were dropped.

The TSE expanded its computer assisted trading system (CATS) to bypass the floor traders and process directly about one-half of its listed stocks. However, the TSE, like the New York Stock Exchange, opposed admitting Instinet to the TSE on the grounds that a private computer trading network is inconsistent, and competes with the exchange's own combination of floor trading and computer system and would represent a loss of regulatory control. Instinet is a privately owned stock trading network based in the United States, which joined the Pacific Stock Exchange in 1980. Since then, it has joined other major stock exchanges in the United States and has become a participant in the NASDAQ over-the-counter market. However, the New York Stock Exchange has not admitted Instinet to its membership. Instinet's application to the TSE was pending before the OSC by mid-1990. At that time, the OSC was also preparing to privatize the Canadian over-the-counter automated trading system (COATS). COATS had been used mainly to assist small and medium companies to raise equity. In 1989, it traded 325 million shares, compared to the TSE's 6.5 million. The OSC has administered COATS since its development in 1986. In early 1990, the commission issued new prudential regulations for over-the-counter transactions, thus establishing the base for converting COATS to a private organization.

Quebec Securities Markets: In the 1980s, the Quebec securities markets gradually recovered from the decline in the 1970s. Most leading dealers had moved to Toronto where they continued to concentrate their activities. While the Montreal Exchange (ME) had been one of the country's most important exchanges, by 1981, it accounted for less than 10 percent of stock trading in Canada. However, introduction of regulatory reforms, proactive provincial policies to stimulate investment and trading, and innovations by the Montreal Exchange generated growth of the province's markets.

In 1983, the Quebec Securities Commission relaxed restrictions on the registration of financial institutions as brokers and on the activities of securities firms. Foreign securities firms were permitted to operate as full-service securities dealers. The provincial government launched a savings plan to stimulate the equities market by granting tax incentives for new share issues and preferential treatment for earnings from investments in securities.

Quebec also encouraged market development by instructing the government-owned institution responsible for managing the Quebec pension plan to invest in the securities of Quebec firms. With C$ 32 billion ($27.6 billion) in assets at year-end 1989, the Caisse de Depot has been a major source of financing and a leading investor in shares. The provincial government also adopted legislation permitting the creation of large financial and mixed financial-commercial conglomerates. The result has been the emergence of financial services holding companies, bringing together insurance companies, trust and loan companies, and even banks. Quebec also removed barriers to financial-commercial links. However, that deregulation was controversial in other parts of Canada and heightened the debate over competing regulatory jurisdictions and the need for federal financial regulatory reform.

For its part, the Montreal Exchange introduced innovative financial products such as commodity futures and options contracts and futures contracts on three-month bankers' acceptances. The ME's most recent "first" in Canada was a futures contract on Canadian Federal Government bonds, inaugurated in late 1989. In addition, given regulatory changes and fiscal incentives, the Montreal Exchange increased its share of the Canadian markets in each of the years 1987-1989. In 1989, the value of transactions in the ME increased by 36 percent to C$ 20.5 billion ($17.3 billion) or 18.8 percent of Canada's total trading of shares. Montreal's trading in options accounted for 26 percent of the total number of options transactions in Canada and for 33 percent of their value.

The Market in British Columbia: The Vancouver Stock Exchange (VSE) accounted for only 3.5 percent of the value of equities traded in Canada in 1989. However, reflecting high turnover in an active market, the volume of transactions on the VSE was equivalent to 31 percent of the country's total. The VSE is a self-styled venture capital market that attracts natural resource companies and small to medium companies seeking to raise equity capital by issuing shares for the first time. In early 1990, approximately 25 percent of the firms listed on the VSE were American, and approximately 75 VSE stocks were quoted on NASDAQ. The VSE's members included many of the large brokerages with headquarters in Toronto as well as smaller, specialized local firms. The province of British Columbia opened up registration to foreign and nonsecurities firms in 1987 in parallel with Ontario. The province also created a Securities Commission in 1987 and adopted financial regulatory reform in 1988. These measures aimed, in large part, to provide better protection for investors in a market characterized by speculative high risk offerings.

Inter-Provincial and Federal Regulatory Cooperation: Securities firms wishing to do business in Canada must meet the requirements of 10 different provinces, in which there are four separate stock exchanges. Moreover, the Federal Government licenses and regulates banks, insurance companies and trust companies, all of which are active in one or more segments of the capital markets (the provinces also license and regulate insurance companies and trust companies). While most provinces take the lead from Ontario on securities regulation, Quebec and the Federal Government have their own priorities. The implications of regulatory differences on capital requirements, permitted activities and investments and restraints on related party transactions have been compounded in recent years by functional integration and ownership links among previously distinct financial institutions.

The provincial regulators have made progress in recent years regarding the exchange of information and coordination. A working group established by provincial regulators, the Canadian Securities Administrators or CSA, elaborated basic "principles of regulation" with respect to the distribution of mutual funds and brokerage activities of financial institutions. In addition, in late 1988, the provincial ministers responsible for financial institutions agreed to set up a conference aimed at harmonization of regulations governing the inter-provincial activities of financial institutions.

As of mid-1990, the Federal Government was not a participant in the ministerial-level consultative mechanism. Nevertheless, the Federal Office of the Superintendent for Financial Institutions (OSFI), established in 1987, and the Department of Finance have communicated frequently with provincial regulatory authorities. To define and clarify respective regulatory responsibilities regarding federally licensed institutions, OSFI and the three most important provinces (Ontario, Quebec and British Columbia) concluded memoranda of understanding in 1988.

The Federal Department of Finance and OSFI have also asserted the Federal Government's authority to influence both the right of establishment and the subsequent operations of foreign financial institutions. They insisted on the right to review and approve (or disapprove) the entry into Canada of foreign firms, even if those firms were not seeking a federal license. They also became involved in influencing the interpretation and application of provincial regulations governing the operations of foreign firms that were registered and regulated by the provincial governments and not by OSFI.

This unifying role by the Federal Government was encouraged and supported by the securities industry. The Federal Government also assumed a more active role in representing Canada in international discussions of financial services and in dealing with other countries on financial regulatory matters. This was a logical outflow of the federal role in the U.S.-Canada Free Trade negotiations. Other manifestations included the involvement of OSFI in the Basel Agreement on capital adequacy and the involvement of Department of Finance in the financial services aspects of the Uruguay Round and representations to U.S. regulatory agencies. Provincial regulators were also active internationally, participating, for example, in the International Organization of Securities Commissions (IOSCO).

Canadian Self-Regulatory Organizations: As of mid-1990, there were five Canadian self-regulatory organizations: the four stock exchanges (Toronto, Montreal, Vancouver and Alberta) which were responsible for their own and members trading arrangements and the Investment Dealers Association. In addition, there were two other private sector organizations in the Canadian securities industry with important roles in developing and monitoring business practices, protecting investors and providing a necessary national perspective that bridges the various provincial and federal regulatory jurisdictions. They were the Canadian Investors Protection Fund (CIPF), which is funded entirely by the five SROs, and the Investment Funds Institute (IFI). The Canadian Securities Institute, which is owned by the five SROs, is the education arm of the Canadian securities industry that develops and conducts the industry’s various qualifying examinations.

The IDA was the single most important securities industry self-regulatory organization. It was based in Toronto and had a government and regulatory affairs office in Ottawa and seven regional councils. The IDA helped to develop effective rules and regulatory procedures for securities activities.

It assisted new firms in preparing applications and meeting the requirements for registration as securities or investment dealers. The IDA conducted training sessions and seminars, sought to identify problems by monitoring its members' operations and represented industry views before government agencies. Finally, the IDA actively contributed to the efforts of the International Council of Securities Dealers and self-regulatory associations to encourage harmonization of business practices and securities regulations internationally.

The Canadian Investors Protection Fund was sponsored by the stock exchanges and the IDA. It evolved from the earlier National Contingency Fund (NSF) and should enhance financial resources and provisions for protecting retail customers' cash and securities. Securities firms were required by law to segregate fully paid securities kept on behalf of customers from their own. Their clientele thus were largely unaffected by financial difficulties of the member institutions themselves. Like the NSF, the CIPF served mainly to protect noninstitutional customers from fraud. Based on member assessments in early 1990, it had cash resources of approximately C$ 24 million ($20.5 million), and a bank line of credit of C$ 33 million ($28.1 million). Commencing in the summer of 1990, the aggregate of customers' general accounts were covered up to C$ 250,000 ($213,200).

The Investment Funds Institute was the industry association for firms engaged in the mutual funds business. Its members included banks, insurance companies and securities firms, as well as companies that specialize in mutual and closed-end funds. The IFI was not truly an SRO. It promoted professionalism and favorable business practices through a large training program, and it monitored trends and developments in the investment funds sector. It did not develop or enforce its own regulations, nor did it deal directly on behalf of its members with the predominately provincial regulators responsible for mutual fund companies and activities. However, in Ontario, at the request of the OSC, the IFI was engaged in consultations with counterpart organizations in the U.S. and other countries to encourage exchange of information on operations and regulations and to develop recommendations for promotion of cross-border mutual fund business and regulatory harmonization.

U.S. Presence in the Market

Prior to 1969, foreign securities firms operated without restraint in Canada. In that year, a leading U.S. firm acquired a Canadian investment dealer. Growing fears of foreign inroads in the industry triggered a nationalist reaction, and in 1971, Ontario limited foreign ownership of a securities firm to 10 percent for a single nonresident and 25 percent in the aggregate. This move not only precluded acquisition of a Canadian firm; it blocked the entry and establishment of any wholly owned foreign company. The 26 foreign firms already in Ontario were grandfathered; however, in 1974, they were limited to growth in assets not to exceed the average rate for the major Canadian firms. Quebec decided not to restrict foreigners, but for other reasons was no longer the financial capital, and was not an attractive alternative for U.S. firms. The other provinces followed Ontario's lead.

By the late 1970s, all but four U.S. securities firms had surrendered their licenses to operate a full-service securities business in Ontario. The two largest, Merrill Lynch and Prudential-Bache, had seats on the Canadian stock exchanges and were primary dealers in Canadian government securities. The grandfathered firms and approximately ten nonregistered U.S. firms also were active in private placements, large trades with institutional investors and secondary market trading of securities issued by governments and selected financial institutions. Ontario exempted from registration those dealers engaged in only these activities. Two U.S. firms, First Boston and Morgan Stanley, participated in "exempt" activities from offices in Toronto. Three others, Salomon Brothers, Goldman Sachs and Discount Corporation were major players operating "offshore" from New York.

The nature and extent of the U.S. presence in Canada's securities markets changed following the removal of regulatory barriers in 1987-88. By mid-1990, there were 11 U.S. securities firms with established subsidiaries in Toronto. Several of them also had offices in Montreal, Vancouver and Calgary. Three U.S. bank subsidiaries had created securities affiliates to enable them to expand beyond the money market activities previously permitted. Another U.S. bank entered the securities sector by acquiring nearly 50 percent of the equity of a leading Canadian investment firm. All of those firms engaged in the full spectrum of securities business, subject to specific requirements such as membership in a stock exchange, or regulatory provisions on selected activities such as providing investment and financial management advice. Finally, a number of U.S. firms opted for international dealer status and continued to trade in the Canadian markets from "offshore." Five of those firms had access to the Toronto bond broker screens, as permitted by changes in the Ontario regulations in 1987.

By mid-1990, U.S. securities firms and subsidiaries accounted for a small, but growing proportion of IDA membership. The president of a recently established U.S. firm's subsidiary had been selected to serve on the Executive Committee of the IDA Board of Directors. Merrill Lynch Canada was by far the largest U.S. firm with about C$ 50 billion ($42.6 billion) in capital. Merrill had seats on all the stock exchanges, and its deputy chairman had served on the Board of Governors of the Toronto Stock Exchange. In early 1990, Merrill Lynch announced the sale of its entire retail brokerage network to a leading Canadian investment dealer that had merged with a major Canadian bank. The transaction involved 22 offices across Canada and reduced Merrill Lynch's employees in Canada from 1,500 to 300. It was valued at an estimated C$ 35 million ($29.8 million), and thus reduced Merrill Lynch Canada's capital by more than one-half. In June 1990, Prudential-Bache announced the sale of its retail brokerage business to a leading Canadian investment dealer, the closing of its research department and the transfer of other operations to its New York office. The number of Bache employees in Canada was reduced from about 700 to 35.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The treatment of U.S. firms in Canada's securities sector has improved in three major respects since the 1986 National Treatment Study Update. First, in 1987, the province of Ontario removed the barriers to entry by U.S. firms and removed the restrictions on the grandfathered firms that remained after the full-service market was closed to nonresidents in 1971. Second, at the same time Ontario opened its securities markets to nonindustry firms (both Canadian and foreign) the Federal Government permitted all federally regulated financial institutions to operate securities subsidiaries. Third, in 1989, the Bank of Canada authorized six U.S. institutions -- three securities dealers and three banks -- to function as primary distributors of Canadian Federal Government bonds.

In the process of the reform that permitted entry to new foreign securities firms, the Federal Government asserted its right to review and approve (or disapprove) the applications. The Federal Government's responsibilities and jurisdictions were clear in the case of banks seeking securities subsidiaries. The Federal Government's role was not clear in the case of securities firms subject to provincial regulation. However, supported by the Canadian industry's desire for an increased unifying influence, the federal authorities argued that they should rule on the appropriateness of foreign firms entering any market in Canada. Consistent with the treatment of domestic firms, the U.S. firms also were required to become members of a recognized self-regulatory organization (all chose to join the IDA).

Canada agreed in the financial services chapter of the U.S.-Canada Free Trade Agreement not to restrict the right-of-establishment of U.S. financial institutions for other than normal prudential reasons. In 1987-89, OSFI approved the new status of the four grandfathered U.S. securities firms and authorized the entry of six additional U.S. securities firms. OSFI also approved the applications of four U.S. banks to establish or invest in securities subsidiaries that subsequently registered with the Ontario Securities Commission. However, one of the grandfathered firms experienced considerable delays in obtaining immigration clearances and work permits for American personnel assigned to the management of the Canadian subsidiary. Another U.S. securities firm wishing to open an office in Canada faced delays in the processing of its application, which remained unapproved by mid-1990.

Foreign firms subject to federal regulation or merely clearances from the Federal Government generally enjoy the same opportunities for diversification and expansion as their Canadian competition. However, two U.S. securities firms experienced difficulties in this regard in recent years. One was a firm that had surrendered majority control of its Canadian subsidiary during the period of grandfathering and restrictions on their growth. When the restrictions were removed, the firm and its Canadian partners agreed to the sale of the latter's shares in order to restore the wholly owned status of the company. The federal authorities objected to the transaction and subsequently granted approval only on condition that the firm agree not to seek a bank license. The second firm, one of the previously grandfathered firms, in fact indicated its interest in obtaining a bank license. As noted in the banking chapter, this company finally concluded that a banking license would not be forthcoming in the foreseeable future. Based in part on that judgment, the company withdrew from further discussions without submitting a formal application. It subsequently decided to curtail substantially its commitment to the Canadian market.

In general, the approval process for a banking license from a firm whose parent is not regulated as a bank in its home jurisdiction is complex and raises a number of policy issues and concerns. In the case of the American Express Canada (AMEX) application for a banking license, considerable discussion was required concerning adjustments the company needed to make in order to bring its application into conformity with Canadian law and policy. In the case of the company which broke off discussions, Canadian officials state that at no time was it ever given to understand that it would not be successful in obtaining a banking license.

Provinces have the constitutional authority over the operations of securities dealers; the Federal Government has no direct jurisdictional authority over the operations of securities dealers or subsidiaries. By mid-1990, U.S. firms had no substantive complaints regarding the provincial regulations and regulatory authorities. The only outstanding issue involved the five U.S. firms registered as international dealers and access to the Toronto bond market brokers screens. The Ontario Securities Commission had under consideration a proposal from the Investment Dealers Association to reverse the 1987 liberalization and deny access to the screens by dealers operating "offshore" and without facilities in Ontario. The IDA argued that other major markets (e.g., New York, London, Tokyo) did not permit such access, and that such access by "international dealers" was inconsistent with the OSC's move to universal registration to enhance regulatory control and prudential protection of Ontario's securities markets and investors.

FINANCIAL MARKET DISCUSSIONS

In the U.S.-Canada Free Trade negotiations, the U.S. sought to remove existing barriers to the entry and operations of financial institutions in Canada. That effort was largely successful. It also provided for future consultations between the U.S. Treasury and the Canadian Department of Finance. The U.S. continued to monitor closely the treatment of U.S. financial firms in Canada. It was committed to using the consultative mechanism as appropriate to address possible problems and to ensure that U.S. securities firms, banks and other financial institutions in Canada enjoy national treatment and competitive opportunities equal to those of their Canadian counterparts. The U.S. and Canadian authorities met periodically in 1989 and 1990 to review the implementation of their respective commitments under the financial services segment of the Free Trade Agreement and to discuss the evolution of financial services in Canada and the U.S. These discussions will recur on a regular basis.

CONCLUSION

Significant improvement in Ontario and in federal review of applications for entry. Ontario has permitted (for the first time in 20 years) the entry of foreign securities companies and eliminated restrictions on remaining grandfathered securities companies (of which there were two). At the federal level, grounds for blocking entry are restricted to prudential reasons.

Finally, the Bank of Canada permitted six U.S. companies to become primary dealers in the Canadian government securities market.

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[*] U.S. dollar figures calculated at the following rates:

1985: $1 = C$ 1.3655 AA
1986: $1 = C$ 1.3895 AA
1987: $1 = C$ 1.3260 AA
1988: $1 = C$ 1.2307 AA
1989: $1 = C$ 1.1840 AA
1990: $1 = C$ 1.1726 (June 1, 1990)

AA = Annual Average

9. European Community - Banking

SUMMARY

This chapter is different in that American financial services firms have yet to operate under all of the regimes described in this chapter and in the chapter on securities, since most of the regimes have not yet come into effect.

The European Community (EC)* is engaged in creation of an internal market by January 1, 1993 that will permit authorized Community credit institutions (banks) to provide commercial and investment banking services cross-border and by branching throughout the Community. The single market is based on the three principles of home country control, minimal harmonization of essential regulations and mutual recognition of national supervisory systems.

The single license or passport for operation on an EC-wide basis would be available to banks established in an EC Member State, including subsidiaries of non-EC firms, on a national treatment basis. The license would not be available to an EC branch of a non-EC firm.

U.S. Treasury Department officials met, in 1988 and 1989, with EC policy officials to express concern about a particularly restrictive reciprocity provision in the Second Banking Directive, potentially requiring mirror-image reciprocity. Federal Reserve officials had similar discussions with their counterparts. The EC has since revised the Directive, which now provides for reciprocal national treatment for non-EC firms.

As of year-end 1989, U.S. banks operated 137 branches with assets of $126 billion and 204 subsidiaries with assets of $104 billion in the 12 Member States of the European Community.

At the end of 1989, 79 banks from the 12 Member States of the European Community operated 69 agencies with assets of $15.4 billion, 112 branches with assets of $108.5 billion, and 30 subsidiaries with assets of $41.5 billion. European Community banks maintain 159 representative offices in the United States.

OVERVIEW

Domestic Banking Market

In 1957, the six original members of the European Community ratified the Treaty of Rome. The opening lines of the Treaty spelled out the goal in specific terms: "The

Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability and closer relations between the States belonging to it."

While the Community adhered to this goal from 1957 onwards, achieving it proved to be elusive. The approach used to open up markets was based on removing barriers for goods and services by a very detailed harmonization of law, which required unanimity voting and often took years to reach fruition. Only limited progress toward achieving a common market was realized.

By 1985, the heads of state or government of all the Member States specifically asked the Commission to put forward concrete proposals to achieve the objective of a common market by 1992. In June 1985, the Commission produced a "white paper," which unlike previous attempts aimed to create, step by step, an integrated and coherent economic framework. The paper identified many of the existing physical, technical and fiscal barriers which frustrated the achievement of a common market, and put forward roughly 300 legislative proposals required for the removal of these barriers.

Based largely on the general framework requirements identified in the white paper, the Single European Act came into force on July 1, 1987. This Act replaced the original Treaty requirement for decisions to be taken by unanimity with a qualified majority as regards measures which have as their objective the establishment and functioning of the internal market. Another major aspect of this Act was the establishment of a "cooperation procedure," which allows the European Parliament greater input to the Community's legislative process. The procedure also requires closer liaison among the European Commission, the Council and the Parliament. Finally, the Act required the Member States to undertake only "essential" harmonization of laws and regulations, and based supervision of markets on the theory of mutual recognition of regulatory regimes and home country control.

Liberalization of financial services is to play a major role in the achievement of the single market objectives. A report was prepared for the Commission on the economic consequences of completing the internal market (the Cecchini Report). Basing its figures on a survey conducted on banking, securities, and insurance, the report forecast consumer and industry gains of ECU 22.0 billion ($26.7 billion at a July 1, 1990 exchange rate of $1 = ECU .8234) in financial services for eight of the Member States. The report went on to highlight the enormous price differentials (50 percent and over) between similar financial products in different countries, with the widest margins being found in motor insurance, home loans, consumer credit and securities. The report predicted that if the Single Market Program were implemented, prices would likely fall the farthest in Belgium, France, Italy and Spain, although substantial falls were also expected in the United Kingdom, West Germany and Luxembourg.

The Single Market Program for Banking: With passage of the First Banking Directive (77/780/EEC) in 1977, the EC established a broad regulatory framework with a view toward creation of a common market in banking. The First Banking Directive has since been amended by the Second Banking Directive. Under the First Banking Directive, branches of credit institutions having their head office in another Member State or third country are subject to host country authorization. The directive specifies minimum authorization requirements, some of which have been addressed in subsequent directives.

While the Second Banking Directive will govern subsidiaries of third country financial firms, the First Banking Directive will continue to apply to branches of third country financial institutions. Member States are not allowed to afford more favorable treatment to third country (i.e., non-EC) branches than that accorded to branches of Member State banks. Reciprocity is employed as a possible basis for agreements by which the Community could provide third country institutions with identical treatment throughout the EC. However, this provision is different from that of the Second Banking Directive and may, in fact, first require that the EC formulate a position on branches, which it has yet to undertake.

The purpose of the Single Market Program for banking is to bring about a unified European banking market in which banks, controlled from their home country by their own supervisory authorities, will be able to provide services throughout the whole of the Community market either from their head offices or by establishing branches, or both in any combination, as easily as they can in their home Member States. There are four pieces of legislation by which this will be achieved, with the Second Banking Directive as the linchpin. The other three are on Annual and Consolidated Accounts, Own Funds and the Solvency Ratio.

The Second Banking Directive: The Second Banking Directive was enacted by the Council in December 1989. Member State parliaments are now in the process of enacting it into national legislation, and it is to go into force on January 1, 1993. This directive provides for a single banking license covering the whole territory of the Community, in place of up to 12 separate licenses and supervisory authorities. (Note: Non-EC banks may operate under this Directive only if they opt for the subsidiary form of organization in at least one of the twelve Member States and all branches, offices or other units in the other 11 Member States are under the control of the subsidiary. As noted above, U.S. branches that are controlled directly by the U.S. parent will continue to be regulated solely by host countries.)

Under this license (or single passport, in Community jargon), credit institutions may engage in any of 14 activities (full list at appendix) throughout the Community that would be subject to supervision by home country authorities. The permissible activities are based on a "liberal all-purpose bank model," which, in effect, allows commercial banks to undertake the range of activities normally associated with universal banking, such as practiced in Germany.

Annual Accounts and Consolidated Accounts: The Directive on Annual Accounts and Consolidated Accounts (86/635/EEC) harmonizes rules on the preparation, publication and audit of annual accounts and consolidated accounts by banks and other financial institutions. Under this Directive, a bank having its head office in one Member State shall publish its annual accounts and consolidated accounts in all Member States in which it is established.

Own Funds: The Directive on the Own Funds of Credit Institutions (89/299/EEC) establishes Community-wide basic standards for bank capital. The Directive lists the types of funds which may be considered in the Own Funds calculation and specifies the maximum amount which may be included. The Directive is related to the capital standards set forth by the Committee on Banking Regulations and Supervisory Practices of the Bank for International Settlements.

Capital Adequacy (Solvency Ratio): The Directive on a Solvency Ratio for Credit Institutions (89/647/EEC), the capital adequacy directive, was also enacted in late 1989. The directive sets out a series of "risk weightings" from zero percent for capital items such as cash on hand to 100 percent weightings for items such as assets denominated in national currencies of countries which are in serious arrears.

U.S. Presence in the Market

U.S. banks have a substantial presence in EC countries and in turn EC banks have a substantial presence in the United States. As of year-end 1989, U.S. banks operated 137 branches with assets of $126 billion and 204 subsidiaries with assets of $104 billion in the 12 Member States of the European Community.

In general, EC branches of U.S. banks are located in major financial centers and are engaged primarily in wholesale banking activities. Branches located in London accounted for more than two-thirds of the $126 billion in total assets at EC branches of U.S. banks as of December 1989. The EC subsidiaries of U.S. banking organizations include banks (some of which engage in securities operations), investment firms and finance and leasing companies. Nearly half of the total assets of U.S. bank subsidiaries in the EC was accounted for by subsidiaries located in the United Kingdom.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Title III, articles 8 and 9, of the Second Banking Directive, deals with "Relations with Third Countries." The initial draft of this Directive provided that where a third country does not grant Community credit institutions equivalent market access comparable to that granted by the Community to credit institutions from that third country, the approval of a license for a credit institution from that third country would be held in abeyance while the Commission negotiated equivalent market access with third country authorities.

This section was substantially modified, after close consultations between the Community on one hand, and the United States, other trading partners and commercial banks on the other, to approximate a national treatment standard. The Second Banking Directive now states that if a credit institution from a third country applies for a license and the Commission, based on an earlier investigation, finds that Community credit institutions are denied national treatment (i.e., the same treatment as domestic institutions) in the third country, the Commission may initiate negotiations to remedy the situation. With the approval of a qualified majority of Member States, the Commission could also suspend new applications for licenses to credit institutions from that third country while such negotiations are underway for a period of up to three months. This is, in effect, a reciprocal national treatment standard.

This section also calls for the Commission to undertake negotiations with a third country when that third country does not grant Community credit institutions market access comparable to that offered by the Community. (The prior approval of a qualified majority of the European Council is required.) The purpose of such negotiations is to obtain comparable market access for Community financial institutions in third country markets. Under the Second Banking Directive as enacted, there are no penalties imposed on the third country should negotiations for comparable access fail.

As stated in the Overview section above, American financial institutions (and, in fact, EC and financial institutions of all other countries) have yet to operate under this Single Market legislation. We cannot judge with precision whether or not this new environment will be one free of discrimination, since implementing legislation by the 12 Member States has yet to be enacted. However, Article 50 of the Treaty of Rome ensures that companies established as subsidiaries under the laws of a Member State are EC firms and will receive full Community (i.e., national) treatment.

We also note with some satisfaction the steps the European Community took to refine the reciprocity provision of the original draft of the Second Banking Directive, so as to take into account the views of the United States and its other trading partners. These improvements include: (1) dropping the automatic suspension of applications pending a reciprocity review; (2) "grandfathering" of existing foreign subsidiaries; (3) movement from mirror-image reciprocity to a reciprocal national treatment standard, and (4) greater political control and procedural checks to be exerted over the use of reciprocity powers.

Despite this softening of reciprocity, the implied threat remains a potentially powerful instrument. Senior United

States officials have pointed out, both publicly and privately, to their counterparts in the Community our uneasiness with this "club in the closet." We are working closely with the U.S. domestic and European offices of American financial institutions to ascertain the likely effects of these provisions on their operations, and they are aware of our interest in learning of any discrimination that might be taken against them.

With regard to capital adequacy, U.S. financial firms have expressed two concerns. The first, not entirely an issue of national treatment, is whether U.S. financial institutions will have the ability to maintain low-cost financing at the parent level and then move capital as necessary into a subsidiary. The second concern is whether a "level playing field" will be maintained with regard to capital requirements between investment firms and banks, which is the stated objective of the EC Commission. (See chapter on EC Securities.) U.S. banking institutions have indicated that their preference is to control capital on a consolidated basis, allowing flexibility in placing capital where it is needed. These interests must be balanced against the Community's need for adequate safety, soundness and prudential supervision. Community officials have indicated that they believe the banking Capital Adequacy Directive meets both their prudential concerns and the concerns expressed by U.S. financial institutions.

FINANCIAL MARKET DISCUSSIONS

The original proposal of the EC Second Banking Directive contained a very restrictive reciprocity provision, potentially requiring mirror-image reciprocity. During 1988-1989, Treasury Department and Federal Reserve officials met with both EC officials and their EC Member State counterparts to express concern over and seek elimination of the reciprocity provision. The EC subsequently revised the Directive - at least partly in response to U.S. concerns - to provide for reciprocal national treatment. However, the Directive still provides for sanctions when third countries do not provide national treatment and negotiations when they do not provide the same competitive opportunities available to their firms in the EC. Meetings between senior Treasury and EC policy officials and staff continued in 1990, to discuss potential developments both in the EC and the United States. The Treasury Department will continue to monitor developments to avoid potential discrimination against U.S. firms as Member States pass implementing legislation.

CONCLUSION

Reciprocal national treatment for non-EC firms will apply under the Second Banking Directive. U.S. and other financial institutions have yet to operate under the Single Market legislation for banking which is to take effect January 1, 1993. The Second Banking Directive, the centerpiece of the legislation for banking, offers U.S. financial institutions reciprocal national treatment. (The U.S. strongly opposed an initial proposal which envisaged possible mirror-image reciprocity.) It appears unlikely that U.S. banks will be subject to sanctions under the Directive's reciprocity provision. With reciprocity remaining, however, it is not certain that the new environment will be completely free of discrimination. In the absence of Member State implementing legislation, there is a possibility that discrimination might occur in the future. Nevertheless, the EC maintains that it is prepared to offer U.S. banks national treatment provided that EC banks receive national treatment in the U.S. The Second Banking Directive provides for substantial liberalization of the operations of U.S. bank subsidiaries established in the EC and provides grandfathering to those established before 1993.

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* European Community Member States are Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom.

Appendix

Annex to the Second Banking Directive

Business which is integral to banking and shall be included within the scope of mutual recognition:

1. Deposit-taking and other forms of borrowing;

2. Lending (1);

3. Financial leasing;

4. Money transmission services;

5. Issuing and administering means of payment (credit cards, travellers cheques and bankers drafts);

6. Guarantees and commitments;

7. Trading for own account or for account of the customers in:

    (a) money market instruments (cheques, bills, CDs, etc.),

    (b) foreign exchange,

    (c) financial futures and options,

    (d) exchange and interest rate instruments, and

    (e) securities;

8. Participation in securities issues and the provision of services related to such issues;

9. Money broking;

10. Portfolio management and advice;

11. Safekeeping of securities;

12. Credit reference services; and

13. Safe custody services.

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(1) Including in particular:
-- consumer credit,
-- mortgage lending,
-- factoring and invoice discounting, and
-- trade finance (including forfeiting).

10. European Community - Securities

SUMMARY

The European Community (EC)* is engaged in the creation of an internal market by January 1, 1993 that will permit authorized Community institutions, both investment firms and banks, to provide investment services across borders and branch throughout the Community. The single market is based on the three principles of home country control, minimal harmonization of essential regulations and mutual recognition of national supervisory systems. The new rules will open to nonbank investment firms and banks the opportunity to join stock exchanges and financial futures and options exchanges in host Member States.

The single license or passport for operation on an EC-wide basis will be available to institutions established in an EC Member State, including subsidiaries of non-EC firms, on a national treatment basis. The license will not be available to an EC branch of a non-EC firm.

Harmonized rules have been adopted but not fully implemented to create a single market for the issuance of securities and trading of securities and shares of open-end mutual funds on an EC-basis. These rules will become fully operational when the Member States have passed legislation to bring Community-agreed rules into effect in their individual territories.

Securities issued by EC-chartered institutions will benefit from mutual recognition by Member States, other than the approving Member State, of disclosure documents required for listing securities for sale on a stock exchange or for the public offering of securities. The financial instruments of non-EC firms do not receive equivalent treatment to those of EC firms. The disclosure document (prospectus) for the security of a non-EC issuer would not benefit from the single market since the document must be separately approved by national authorities of each EC member country for listing on national exchanges or for a public offering of securities. The directives anticipate negotiations with third countries to obtain reciprocal recognition of disclosure requirements.

Reciprocal national treatment is incorporated in the proposed Investment Services Directive.

OVERVIEW

Liberalization of Capital Movements: One crucial aspect to the Single Market Program was the decision to remove all existing barriers from the flow of capital between Member States. Starting in 1984, the Community undertook a gradual, broad-based process, resulting in the virtual elimination of exchange controls in most EC countries by the end of 1988. Over the course of the 1980s, capital controls were gradually removed. In June 1988, the lifting of the controls on capital movements was provided for eight member states, effective July 1, 1990, with Ireland, Greece, Portugal and Spain being given additional time, if necessary, to remove such barriers.

While such barriers did not discriminate against U.S. firms, their removal has been a major signal that the Community is setting the stage for the strengthening and internationalization of financial markets in Europe. Such moves not only hold commercial opportunities for U.S. firms, but also highlight the Community's goal of making financial centers within the Community strong competitors among the major financial markets of the world.

A Single Securities Market: The Community is creating a European financial market without restrictions where investors can issue and trade securities across national frontiers freely and without hindrance. One major reason for liberalization is the Community's perception that the rapid internationalization of the securities markets requires the Community to create a domestic market that can rival the principal securities markets of the United States and Japan. Another reason for the liberalization has been the belief that omissions and differences in information required to be made available to the public form a "barrier" to the free movement of capital between the Member States. In addition, deep securities markets would underpin and stimulate economic growth in the Community.

As early as 1972, the first proposal was made for a directive on the admission of securities to stock exchange listing and the information to be disclosed for investor protection. This and related proposals grew into a series of directives affecting listed securities, which were enacted in the late 1970s or during the 1980s, including particularly the following directives that were to be implemented by the Member States by June 30, 1983:

-- The Directive on Admission of Securities to Official Stock Exchange Listing (79/279/EEC) sets out the conditions that must be met by issuers of securities.

-- The Directive on Prospectus Requirements or Listing Particulars (80/390/EEC) lays down the requirements for information that must be published when shares, debt securities and certificates representing shares are admitted to stock exchange listing.

-- The Directive on Reports to be Published by Companies Whose Shares are Listed on Exchanges (82/121/EEC). Issuing companies must publish half-yearly reports on their activities, profit and losses.

As of early August 1990, all of the Member States implemented these directives except for Belgium, Ireland, Portugal and Spain. Belgium was found to be in noncompliance by the European Court of Justice. Spain and Portugal were given additional time to implement the directives.

In 1989, the Commission secured adoption of the Directive on the Prospectus for Transferable Securities Offered to the Public (89/298/EEC), which sets common standards for the prospectus required to issue securities to the public. Member States are required to pass implementing legislation by April 17, 1991.

The Listing Particulars Directive and the Public Offer Prospectus Directive impose on issuers certain disclosure requirements, which do not discriminate between issuers controlled by EC nationals and foreign-controlled enterprises as far as the content is concerned. For example, a U.S. subsidiary in Germany is treated as a domestic German user, whereas a U.S. incorporated German subsidiary is treated as a domestic U.S. firm. Foreign incorporated firms are not obliged to present annual accounts according to EC directives on annual accounts, provided they give equivalent information.

Foreign and domestic firms are subject to the same disclosure requirements. Only in the case of simultaneous offering of securities in two or more Member States, or where application for simultaneous admission to official listing on the stock exchanges of two or more Member States are made, may difference in treatment occur.

In these two instances, securities sold cross-border into the EC by a U.S. incorporated issuer would not be treated the same as securities of an EC-chartered institution. The

U.S. securities could be denied the benefit of reduced costs in fulfilling disclosure (prospectus) requirements for stock exchange listing or public offerings of securities that is available to EC securities. The prospectus for EC securities must be mutually recognized by other Member States once approved by one Member State. For securities of an issuer that is not incorporated in an EC Member State, approval and hence mutual recognition is not automatic, but remains the discretion of each Member State. Equal treatment with securities of issuers incorporated in a Member State is subject to bilateral negotiation of "reciprocal recognition" of disclosure requirements of a non-EC state.

Other directives have either been adopted or proposed to regulate securities and financial markets. The Directive on Insider Dealing (89/592/EEC) is intended to improve investors' confidence in the fairness of securities market operations; the proposed Directive on Takeovers sets forth procedures to follow during the bidding process, and the draft Directive on Money Laundering, which is applicable to all kinds of financial institutions, is intended to bring integrity to the financial markets.

The Directive on Large Shareholdings Disclosure (88/627/EEC) provides that upon acquisition or disposal of shares, an ownership interest in a company listed on a stock exchange must be disclosed by a shareholder when that interest reaches or falls below certain thresholds, the first of which is set at 10 percent of voting shares.

Mutual Funds: Directive (85/611/EEC) on Undertakings for Collective Investment in Transferable Securities (more commonly known as the UCITS Directive) covers the coordination of laws, regulations and administrative provisions to permit cross-border sales of units of investment companies or unit trusts (i.e., open-end mutual funds). Effective October 1989, units of a UCITS that are authorized in a Member State in accordance with the basic standards for investor protection set forth in the Directive may be sold under home-country control throughout the Community in the Member States that have enacted implementing legislation.

Mutual funds of U.S. institutions sold cross-border to the EC would be subject to national regulation. Open-end mutual funds set up and approved for sale within the EC on the same basis as EC mutual funds may be offered throughout the Community by firms authorized to provide investment advice under the Investment Services Directive or Second Banking Directive; however, distribution modes remain subject to marketing rules and practices of the individual Member States.

There are no comprehensive statistics to describe the size of the market that would result from the combined securities markets of the EC Member States. However, based on OECD data, generally for the largest members, completion of the internal market in securities holds significant promise of major market opportunities for participating intermediaries. Data from the OECD put new issues of bonds in 1987 in nine of the 12 Member States (Belgium, Denmark, France, Germany, Italy, Luxembourg, Netherlands, Portugal and the United Kingdom) at a combined total of $437 billion, which was roughly half of the $760-800 billion of new bond issues in the United States. On the other hand, new issues of shares in 1987 in the nine EC countries ($95 billion) were nearly double those in the United States ($53 billion). Data for new issues are strongly influenced by market conditions, which may favor borrowing on the Euromarkets rather than domestic markets or postponement until conditions turn more favorable.

Figures compiled from data published in the International Finance Corporation's Emerging Markets Fact Book 1990 give further indication that the combined equity markets of the Community could become a formidable competitor once harmonized disclosure and listing requirements are fully implemented by the Member States. Market capitalization of the stock exchanges of the 12 Member States, excluding Ireland, of $2.2 billion in 1989 was nearly two thirds the capitalization of the stock exchanges in the United States ($3.5 billion) with 5,499 domestic companies listed on EC exchanges compared to 6,727 companies listed on U.S. exchanges. Shares traded in the EC, valued at $1.248 billion, were over half the value traded in the United States ($2.015 billion).

U.S. Presence in the Market

There is no single authoritative source for data. The National Association of Securities Dealers reported that as of June 1989, there were 37 U.S. securities firms operating 90 branches in the Member States. Nine of the U.S. firms had branches in more than one EC country -- among them the United Kingdom, Netherlands, France, Belgium, Germany, Greece, Italy, Spain and Luxembourg. Only subsidiaries would benefit from the license to market services throughout the EC as proposed in the Investment Services Directive. According to the Bureau of Economic Affairs of the Commerce Department, at year-end 1989, 12 U.S. securities firms operated 83 affiliates, most of which were incorporated as subsidiaries, in the nine EC countries reported above. (Firms with assets, sales or net income of less than $3 million in the EC in 1982, or firms acquired or established since 1982 with assets, sales or net income of less than $10 million in the EC are not included in the Commerce Department data. Nor do the data include affiliates of U.S. banks engaged in securities activities in the EC.)

Banking organizations in the United States may conduct certain securities activities outside the United States to an extent greater than permitted in the United States; the activities generally must be conducted through subsidiaries. Under Federal Reserve Board Regulation K, subsidiaries may: *inter alia* underwrite and deal in debt and equity securities (subject to limitations applicable particularly to equity securities); manage mutual funds if the shares are not sold in the United States; and provide investment advisory services. As of December 1989, the Federal Reserve Board estimates that 14 U.S. banking organizations were conducting securities activities in 54 subsidiaries located in EC countries.

U.S. banks have felt particularly constrained by the limitations imposed on the amount of equity underwriting and dealing in which their subsidiaries may engage. However, subsidiaries of U.S. banking organizations have been able to engage in a substantial way in underwriting, dealing and distribution of debt securities and have been significant participants in the Eurobond and Eurocommercial paper markets in London. The debt underwriting by foreign subsidiaries of U.S. banks is subject to overall bank lending limits.

There are three areas in which investment management companies seek participation in the EC: 1) managing European mutual funds; 2) selling U.S.-registered mutual fund shares in the EC; and 3) providing investment advisory services to non-mutual fund clients, such as pension funds. While there is no systematic information describing the size or extent of activities of U.S. companies, there is anecdotal information to describe generally the areas in which U.S.-owned institutions are involved in the EC.

There have been minimal sales of U.S. mutual funds, although some U.S. funds have been sold successfully in Germany. Such cross-border sales from the United States require registration of the fund in each individual Member State in which fund shares are to be marketed and, if successful, fulfillment of the requirements of the particular state for marketing shares. In several European countries, legal barriers prevent U.S. funds from registering. In addition, U.S. tax laws have served as a significant disincentive to European investment in U.S. funds. U.S. funds are at a disadvantage compared to local funds because they must distribute all of their income and capital gains, and dividends paid to foreign investors are subject to U.S. withholding tax and information reporting.

U.S. securities firms and mutual fund advisers in the United States have launched a number of non-U.S.-registered funds (offshore funds) in EC countries, principally in Luxembourg and Ireland, for sale outside the United States in Europe and Asia, including Japan. Such funds have the advantage of the tax regime of the country in which they are organized. Funds organized in an EC country are able to take advantage of the UCITS Directive permitting mutual funds to be sold cross-border throughout the Community if they meet the requirements of the Directive. Even so, impediments to EC-wide sales exist in the tax, marketing, and distribution rules and practices that vary from country to country in the Community. U.S. mutual fund managers generally have not developed direct marketing capabilities and usually have relied upon local institutions, which can put U.S. funds at a disadvantage in relation to local funds. In some instances, distribution through universal banks in countries such as Germany may be the norm, making it difficult to overcome customary practices. These practices present a challenge to fund managers to develop distribution channels that will reach retail and institutional customers. Such problems are not unique to the funds of U.S. institutions in Europe and will affect all other foreign competitors, EC and non-EC, in the markets of the individual states.

A third avenue for sales of mutual funds in the EC is through the EC subsidiaries of U.S. securities firms and U.S. banks located in the EC and through companies formed by U.S. investment advisers and registered in the EC to undertake portfolio management and advice. These institutions can sell shares of the mutual funds that they establish and register locally, as well as other products. They would benefit from the ability to be authorized as investment firms under the proposed Investment Services Directive and to sell EC-registered funds cross-border within the EC. These firms also provide investment advice for non-mutual fund clients in the EC.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Various directives were approved in the 1970s and 1980s to create a single market for securities products. These directives, however, did not address the removal of barriers to intermediaries such as brokers, dealers, and fund managers operating across the EC. Such barriers have prevented these institutions from developing economies of scale within European markets that would enable them to compete more effectively with the domestic institutions of larger securities markets of the United States and Japan. The Single Market Program in securities intermediation will be achieved through the enactment of several directives -- principally the proposed Investment Services Directive and related Capital Adequacy Directive -- as well as the Second Banking Directive (89/646/EEC), which provides certain securities activities among the services approved for banks.

In general, there is no evidence of any intention by the Commission to discriminate against U.S. institutions engaged in or seeking entry to the securities business. While two of the three principal directives have not been adopted and no firm has yet operated under these directives, it appears that national treatment would be afforded to U.S. commercial banks as well as U.S. securities firms operating subsidiaries under these directives.

Investment Services Directive: The primary objective of the proposed Investment Services Directive is to provide authorization that grants a European "passport" to professional intermediaries to carry out securities-related services. The Directive will allow an investment firm, once authorized in its home Member State, either to establish branches in other Member States, or to provide services in them without establishment, and without separate authorization by the host Member State.

An investment firm is defined as any person providing an investment service in any instrument listed in the Annex to the Directive. The list of services includes broking, dealing, market-making, portfolio management, offering underwriting services, professional investment advice, safekeeping and administration of and in any of the instruments specified in the Directive: 1) transferable securities, including units of UCITS (mutual funds); 2) money market instruments; 3) financial futures and options; and 4) exchange rate and interest rate instruments. (See the Appendix to this Chapter.)

The Investment Services Directive would apply to credit institutions (banks) not already authorized under the Second Banking Directive for the investment activity concerned, and certain provisions of the Investment Services Directive would apply to credit institutions that have been authorized by their banking license to engage in securities business. Under the Second Banking Directive, banks will be authorized to engage in securities activities such as trading in securities for their own account or for the account of customers; participation in share issues and the provision of related services; advice and services related to mergers and acquisitions; portfolio management advice and the safekeeping of securities. (See the Appendix to the Chapter, "European Community - Banking.")

The Investment Services Directive contains a reciprocity provision nearly identical to the reciprocal national treatment provision provided in the Second Banking Directive and discussed in the chapter, "European Community - Banking." Authorization of investment firms may be conditioned on Community firms' receiving the same competitive opportunities as domestic firms, and effective market access in the applicant's country. Authorization decisions could be suspended for six months and the suspension could be continued by decision of the Council in light of the result of negotiations with the third country.

The Directive also provides that authorized investment firms and credit institutions will have the opportunity to become members of host country stock exchanges and organized securities markets, as well as financial futures and options exchanges, by setting up a branch or subsidiary on the basis of rules governing the exchange. Where a market operates with electronic access and, therefore, without the requirement for a physical presence, investment firms may become members on a similar basis without having any establishment in the host Member State. The host authorities would establish rules for the operation of terminals in remote locations, recordkeeping, and inspection of the office originating trades, including offices in another Member State. Thus, home Member States must permit a host stock exchange or market to provide appropriate facilities within the home Member State's territory in order to permit their investment firms to become members of the host exchange or market.

The Investment Services Directive is currently before the Council for formulation of its "common position." The European Parliament has concluded its "First Reading" deliberations and rendered its opinion. The Council is currently undertaking private negotiations with the Member States in order to reach agreement on the common position by the end of 1990. Once a directive reaches that stage, it is in a form that is almost identical to its final shape, and usually is enacted within six months. The U.S. securities industry is concerned that the Investment Services Directive should be implemented at the same time as the Second Banking Directive in order that universal banks do not gain a head start in using the single passport for conducting securities activities throughout the EC. Differences among the Member States remain to be resolved in order to keep the Directive on the planned schedule. In addition, the companion Capital Adequacy Directive must also be completed and adopted in order to implement the Investment Services Directive.

Capital Adequacy Directive: From the Commission's perspective, the greatest difficulties in harmonizing rules for securities intermediaries have centered on the proposed Directive on Capital Adequacy of Investment Firms and Credit Institutions (the Capital Adequacy Directive). In April 1990, after five drafts, a sixth version was proposed to the Parliament and the Council, which may be enacted by mid-1991.

The problems encountered in defining harmonized rules for capital adequacy revolve around the Commission's desire to construct a "level playing field" between the securities activities of investment firms and the securities activities of commercial banks, while safeguarding the general health of the financial system and providing adequate consumer protection. In statements released with the proposal, the Commission outlined the problem areas it attempted to overcome with this Directive. Generally, the Commission has opted for a system that does not seek to establish identical requirements for all firms, but rather seeks to establish a "broad equivalence" between requirements for credit institutions and those for other types of investment firms. Specifically, it was intended that the rules should not provide an incentive for an investment firm to opt for one institutional structure (bank) rather than another (investment firm). The Commission maintains that further convergence between the two sets of requirements will be achieved once further technical work has been completed.

The proposed Capital Adequacy Directive provides for:

-- the minimum level of initial capital required for authorization of an investment firm (other than a credit institution) according to the nature of the business; and

-- the level of capital to be maintained by investment firms and credit institutions to cover market risks (position risk, foreign exchange risk, counterparty risk, and other risks).

U.S. firms would receive the same treatment in the EC as domestic firms. However, U.S. firms have expressed concern on several points.

Article 4.4 of the Directive would grant Member States the option to require investment firms that are credit institutions to meet either (a) the capital requirements set out in the Solvency Ratio Directive (89/647/EEC) for their entire business, or (b) the same capital requirements as investment firms with respect to their trading activities in bonds and equities and the capital requirements set out in the Solvency Ratio Directive with respect to the rest of their business.

American firms have expressed the opinion that this option is central to creating neutrality of treatment between bank and nonbank investment firms. Thus, if the option is to be effective, American firms would prefer that the option should be mandatory, i.e., that Member States should be required to grant credit institutions under their jurisdiction the option to meet either the Solvency Ratio alone for their entire book, or to substitute the Capital Adequacy Directive requirements for those of the Solvency Directive with respect to their trading book.

As capital requirements for the securities activities of banks have also been under discussion by G-10 central bankers at the Bank for International Settlement in Basle, it would be premature to try to assess the final impact of this directive on U.S. and other banks engaged in securities activities in the EC. Another problem perceived by American firms is that the proposed requirements do not sufficiently allow for reductions in risk arising from hedging and diversification, and that they overestimate the risk associated with certain unlisted securities, such as asset-backed securities, which have become important financial instruments and are increasingly becoming important in the Community.

Finally, American firms believe the proposed requirements also overstate the risk associated with certain forms of settlement, such as delivery versus payment. As a result, they claim the proposed directive seriously overestimates the capital required to assure the safety and soundness of investment firms. Strictly speaking, these are not national treatment issues.

FINANCIAL MARKET DISCUSSIONS

Treasury officials met periodically with EC officials responsible for banking and securities issues beginning in 1988 to discuss concerns about a potential strict reciprocity standard proposed to be applied to banks and securities firms seeking entry and operation within the EC. As discussed in the chapter, "European Community - Banking," the reciprocity provision in the Second Banking Directive was subsequently revised and a parallel provision has been incorporated in the Investment Services Directive. Treasury is continuing to monitor development of the Investment Services Directive to ensure that discriminatory provisions are not introduced.

Treasury also is monitoring developments stemming from interests of the U.S. investment company industry and the EC in the possibility of a mutual recognition treaty that would facilitate cross-border sales of mutual funds.

Finally, the Treasury is monitoring implementation of the banking and securities directives. As noted above, the EC has specifically provided for reciprocal recognition arrangements to be negotiated with third countries on matters of disclosure required for the public offering of securities and the listing of securities for sale on stock exchanges. Treasury is concerned by the potentially discriminatory nature of provisions that provide for mutual recognition that applies only to EC issuers. While such provisions facilitate development of a market in European securities, denial of comparable treatment may impede U.S. issuers. The EC anticipates negotiation of reciprocal recognition arrangements with third countries, which may be difficult for the United States in light of U.S. disclosure requirements.

CONCLUSION

Reciprocal national treatment is incorporated in the proposed Investment Services Directive. Firms engaged in securities activities authorized under the proposed Investment Services Directive will, if the directive is adopted, receive national treatment, as will banks engaged in securities activities authorized under the Second Banking Directive. Both directives provide for national treatment of subsidiaries of non-EC institutions. The reciprocal national treatment provision is nearly identical in the two directives. Where the EC perceives that effective market access in a third country is not comparable to that in the EC, but national treatment is provided, the Community may seek negotiations to obtain comparable opportunities for Community investment firms. In these circumstances, the Commission reportedly would not be authorized to take punitive action to deny entry to a U.S. securities firm.

U.S. securities sold cross-border into the EC will not be treated the same as securities of an EC-chartered institution. They will be denied the benefit of reduced costs in fulfilling disclosure (prospectus) requirements for stock exchange listings or public offerings of securities that is available to EC securities. The prospectus for EC securities must be mutually recognized by other Member States once approved by one Member State. For non-EC securities, approval and hence mutual recognition is not automatic, but remains at the discretion of each Member State. Equal treatment with EC securities is subject to bilateral negotiation of "reciprocal recognition" of disclosure requirements of a non-EC state.

Mutual funds of U.S. institutions sold cross-border to the EC will be subject to national regulation. Open-end mutual funds may be set up and approved for sale within the EC on the same basis as EC mutual funds and may be offered throughout the Community by firms authorized under the Investment Services Directive; however, distribution modes would remain subject to marketing rules and practices of the individual Member States.

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*The European Community comprises: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and the United Kingdom.

Appendix

Annex to the Proposed Investment Services Directive

ANNEX

Investment services coming within the scope of this Directive

Section A: Services

1. Brokerage, i.e., the acceptance of investors' orders relating to any or all of the instruments referred to in Section B below and/or the execution of such orders on an exchange or market on an agency basis against payment of commission.

2. Dealing as principal, i.e., the purchase and sale of any or all of the instruments referred to in Section B below for own account and at own risk with a view to profiting from the margin between bid and offer prices.

3. Market making, i.e., maintenance of a market in any or all of the instruments referred in Section B below by dealing in such instruments on the basis of a commitment to make two-way prices.

4. Portfolio management, i.e., the management against payment of portfolios composed of any or all of the instruments referred to in Section B below undertaken for investors otherwise than on a collective basis.

5. Arranging or offering underwriting services in respect of issues of the instruments referred to in point 1 of Section B below and distribution of such issues to the public.

6. Professional investment advice given to investors on an individual basis or on the basis of private subscription in connection with any or all of the instruments referred to in Section B below.

7. Safekeeping and administration of any of the instruments referred to in Section B below otherwise than in connection with the management of a clearing system.

Section B: Instruments

1. Transferable securities including units in undertakings for collective investment in transferable securities.
2. Money market instruments (including certificates of deposit and Eurocommercial paper).
3. Financial futures and options.
4. Exchange rate and interest rate instruments.

11. Finland - Banking

SUMMARY

Finnish financial markets traditionally have been dominated by banks, reflecting the role of deposits as the major component in household savings and bank credit as the primary source of corporate finance. The markets have been substantially deregulated over the last 10 years, with the elimination of credit rationing, deregulation of interest rates and removal of restrictions on corporations' access to offshore financial markets. Finnish authorities generally would like to see increased competition in Finnish financial markets, especially via the entry of foreign banks.

Foreign banks were allowed to enter Finland as subsidiaries for the first time in 1979, and will be allowed to enter as branches as early as 1991, under the Branch Bank Act which was submitted to the legislature in September 1990. Foreign bank subsidiaries are afforded national treatment in all banking market segments, with the exception of a prohibition on foreign ownership of real estate. National treatment will apply to branches under the proposed Branch Bank Act, which would take effect in 1991. However, the proposed legislation does contain a reciprocity provision regarding branch establishment.

The demands of European integration may lead to further liberalization of Finnish ownership, foreign exchange and capital movements rules. Nevertheless, Finland has not been a profitable market for U.S. banks. When the proposed Bank Act is adopted, all banks established in Finland, domestic and foreign, will be permitted to hold larger percentages of domestic nonfinancial corporate stock in trading portfolios than is currently permitted. By 1992, there will be significantly less difference between Finnish and European Community financial legislation than there is now.

There has been continued improvement and movement toward full national treatment, although some constraints remain.

As of year-end 1989, one U.S. bank operated a subsidiary with assets of $195 million in Finland. This presence represents a decrease of one subsidiary and a net decrease of $67 million in assets since year-end 1985. At that time two U.S. banks operated subsidiaries with assets of $260 million.

At the end of 1989, three Finnish banks operated three branches with $2.3 billion in assets in the United States. Finnish banks maintain four representative offices in the United States. This is an increase of two branches and assets of $2.3 billion since year-end 1985. At that time, one Finnish bank reported a single branch with total assets of $63 million and a representative office in the United States. There has been continued improvement and movement toward full national treatment, although some constraints remain.

OVERVIEW

Domestic Banking Market

The Finnish banking system is based on the universal bank model. There are three separate groups of banks -- commercial, savings and cooperative banks -- that are known as the "deposit banks." In addition, there are specialized credit institutions such as mortgage banks, finance companies, regional development funds and export credit agencies.

Commercial banks have the widest range of operations and services, including trust and investment banking services and international operations. Savings and cooperative banks may offer commercial banking services, but are constrained from paying dividends. The former group is associated with smaller businesses and municipalities, while the latter is associated with households and rural/agricultural interests. Both groups have "central banks" (Skopbank and Okobank, respectively) which are chartered as full-service commercial banks. Their role is to safeguard the solvency of the underlying banking groups. The state-owned Post Office Bank became a commercial bank in 1988. It has outlets in all of Finland's 3,000 post offices, but is reducing this number as a cost-cutting measure. The Post Office Bank handles most government transactions, and its primary customer group is industry.

Banking Institutions in Finland
Year-End 1989
($Millions)

Institution Type	Number	Assets
All Commercial Banks	12	119,144
Foreign Subsidiaries	4	1,205
(U.S. Subsidiaries)	(1)	(122)
All Cooperative Banks	367	21,005
All Savings Banks	211	24,740

Note: Exchange rate used was $1 = markka 4.00 (3/19/90)
Source: Finnish Bankers' Association

Prior to the middle of the 1980s, Finnish financial markets were extremely narrow and dominated exclusively by banks. Household savings were mobilized by tax-free, interest-bearing deposits, and loaned to corporations by banks. The share of securities in household savings was negligible. Interest rates for bank lending were limited by a ceiling set by the Central Bank. Through a cartel arrangement in establishing deposit interest rates, banks were still able to earn wide margins. Close bank\client relationships were the key factor in credit allocation and bank income. Bank branch networks proliferated to develop these relationships. A real money market did not exist during this period, and a tax bias against dividends and capital gains inhibited development of the stock and bond markets.

The Central Bank launched a program of financial market liberalization in the early part of the 1980s. Ceilings on lending rates were abolished in 1986, and the bank deposit rate cartel was formally disbanded this year. The Bank of Finland closed its call window as a major source of marginal bank funding when it introduced a certificate of deposit market in 1987, which led to the creation of market-determined Helsinki interbank offer rates (HELIBOR) for short-term maturities. This increased competition among the banks for both deposits and credit services. The retail banking sector is in the midst of rationalization as banks respond to higher labor costs, narrowing margins, increased availability of foreign loans and investments to customers, and increasing credit losses.

The total size of the financial market in 1988 was markka 586.7 billion ($140 billion),* with bank deposits accounting for 40 percent. Money, equity, and bond markets made up the remainder. This was a drastic shift from the situation in 1980, when deposits represented 74 percent of Finnish financial assets, the stock market only 8 percent, and the money market was nonexistent.

Deposits: The three types of retail banks in Finland compete among themselves for deposits, which have been a cheap source of funding. Commercial banks have a domestic deposit base which is twice that of the cooperative and savings groups combined, and is concentrated in the accounts of the five largest banking houses. At the end of 1988, total domestic deposits equaled markka 238.9 billion ($57 billion), 89 percent of which was in time deposits and 11 percent in checking accounts. An additional markka 79.6 billion ($19 billion) of domestic bank funding came from the money market. Thus, indigenous banks rely upon the more expensive certificate of deposit market for only a quarter of their funding needs. The situation for foreign banks in Finland is the reverse.

The first $500 of capital income (including taxable interest earnings) is exempt from taxes which are applied on a sliding scale for larger yields. This tax break is expected to be gradually eliminated. At present, only interest income from bank deposits paying no more than four percentage points below the Central Bank's base rate is totally exempt from taxation.

Lending: The corporate sector absorbs more than half of all commercial bank lending. The importance of bank credit is eroding as the Finnish equity and bond market grows in importance due to tax changes. Relaxation of capital and foreign exchange controls have afforded all nonfinancial corporations access to international markets for, inter alia, commercial paper and inexpensive Eurodollar, U.S. dollar, and yen financing. With more neutral taxation of capital income and the new credit tax, the choice between equity and debt financing is more competitive. Households are the second largest component of bank lending, with a total of markka 390.8 billion ($91 billion) at year-end 1989. Banks and related special credit institutions are major providers of real estate financing.

Payments: Finland features one of the most advanced payments systems in the world, with a very high ratio of automated teller machines to inhabitants. Additionally, all banks use electronic funds transfer systems, which account for most household and corporate payments. Interbank transfers are effected via magnetic tape. Computerized payment of invoices, direct debiting, provision of machine-readable data on incoming payments, along with payroll and other standing orders, are typical electronic funds transfer services. Point-of-terminal systems are standard equipment in most retail outlets, while home-terminal services are just becoming popular.

International Services: Foreign trade transactions are equivalent to 50 percent of gross domestic product; therefore, trade-related payments and international financial flows feature prominently among the banking sector's services. Starting in the 1980s, Finnish banks supplemented already extensive correspondent relationships with the establishment of subsidiaries and branches abroad. Their international expansion kept pace with the internationalization of the domestic corporate sector. Today there are eight branches and 13 subsidiaries of Finnish banks abroad, supplemented by another 30 representative offices. Rounding out the picture are four consortium banks abroad in which Finnish banks have an interest. Finnish banks are members of the SWIFT payments network. Recently Nordic banks have exchanged minority stock positions to establish regional alliances in anticipation of the European Community's single market and the resulting increased competition.

Regulatory Authority: The Ministry of Finance is the highest banking authority in Finland. It prepares legislation concerning financial markets for Parliamentary consideration. It issues permission to establish bank operations in Finland. Subordinate to the Ministry is the Bank Inspectorate, which supervises and monitors the operation of legally regulated financial institutions, except for insurance companies. The Bank of Finland regulates the financial markets through monetary policy and capital controls. It is the sole issuer of currency and controls the "base rate" to which a major share of the existing credit stock of households still is tied, though reference interest rates are increasingly market related. The Bank of Finland establishes bank reserve requirements and intervenes to influence market interest rates through the certificate of deposit market. It is subordinate to the Parliament's Bank Supervisory Committee.

U.S. Presence in the Market

Foreign banks were allowed to enter the Finnish market as subsidiaries in 1979, with the first foreign bank establishing a unit in 1982. In the case of both indigenous and foreign interests, formal application must be made to the Ministry of Finance for approval. Approval for acquisition by a foreign financial institution of more than 20 percent of a Finnish financial institution is required from the State Council. To date, the Government of Finland has allowed the establishment of four foreign bank subsidiaries, including Citibank, N.A. and Chase Manhattan from the U.S. Chase Manhattan subsequently sold its operation due to poor results.

The Government of Finland has expressed unwillingness to permit foreign acquisition of a controlling interest (defined as more than 20 percent) in an existing domestic bank, nor is establishment of foreign branches in Finland permitted. This latter point is expected to change in 1991 when proposed legislation is accepted by the Parliament. The proposal recommends that foreign branches be permitted entry to Finland with the same rights as domestic commercial banks. The new legislation is expected to be passed within the next 12 months.

The four foreign commercial bank subsidiaries have entered Finland without a preexisting customer base; consequently, they have significantly higher funding costs than indigenous competitors. Their total deposits were markka 1.81 billion ($432 million) at the end of 1988, versus assets of markka 5.4 billion ($1.3 billion). As a result, the foreign operations concentrate on wholesale and investment banking, obtaining funding from the money market, and on linking Finnish customers with parent units located offshore.

In a significant rules change in 1987, the permissible level of bank ownership of voting stock in nonfinancial entities was lowered from 20 to 10 percent. (The draft bank law would permit a higher total to be held by a bank, domestic or foreign, as part of a stock transaction not for the bank's own books.) Previously, banks were able to control most of Finnish industry through interlocking ownership arrangements. This 10 percent limit on ownership and voting stock applies to both Finnish and foreign-owned banks. However, foreign subsidiaries may not own real estate. These limits affect foreign-owned banks more than indigenous banks, which can circumvent stock ownership restrictions through investment banking activities, which require equity participation or portfolio trading. The provisions of the proposed bank law, permitting larger holdings in all banks' trading portfolios, should provide a more level playing field for foreign banks.

The four foreign banks in Finland have not fared particularly well. Those subsidiaries which attempted to compete head-on with indigenous banks have experienced worsening results as the sector has undergone restructuring. Chase Manhattan sold its subsidiary to Sweden's PKbanken in 1987. Citibank pared down its local operations, divesting its securities unit, and transferring other functions offshore. Citicorp improved its 1989 results by emphasizing sectors where it is globally competitive.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Entry and Establishment: As noted above, U.S. and other foreign banks may enter the Finnish market only as subsidiaries or with representative offices. Branch establishment may become possible in 1991, with passage of the proposed Branch Bank Act. Acquisition of an existing domestic bank is possible in principle, but requires Council of State permission which may be given for "special reasons." The relatively small universe of commercial banks mitigates against one coming up for sale; furthermore, the outcome of such an application is uncertain, as the Government has indicated a disinclination to approve foreign acquisition of more than a 20 percent stake.

Minimum capital for a commercial bank is markka 5 million ($1.25 million); this is likely to be increased to markka 25 million ($6.25 million) by 1991. A prerequisite for entry is the provision by the parent bank of a "letter of comfort," guaranteeing the solvency of the subsidiary.

The size of a foreign subsidiary's authorized capital is set at 4 percent of liabilities, with off-balance sheet contingent liabilities assessed at half their value. This has limited the ability of local operations to expand their asset base. The new Bank Act will harmonize capital requirements to reflect the European Community Solvency Directive and recommendations of the Bank for International Settlements. With capital adequacy requirements being adjusted, however, capital increases for foreign banks are expected to be approved, if not required.

Operations: In addition to the limits on their ability to expand via increases in their capital base or acquisition of existing domestic banks, U.S. financial institutions face only one obstacle to national treatment in operations: the limitation on foreign ownership of Finnish real estate. Restrictions on ownership of shares in nonfinancial corporations apply equally to foreign and domestic institutions, as will the relaxation of these restrictions contained in the pending Bank Law revisions.

The prospect of elimination of the current branch restriction is received with mixed reactions by U.S. financial interests. All of the foreign subsidiaries in essence act as enhanced representative offices, using local establishments to generate business for offshore units. The primary advantage of branch presence would be the ability to leverage parent capital ratios to make larger loans in Finland, while side stepping local reporting and disclosure requirements associated with subsidiary status. However, branches are not attractive alternatives for existing subsidiaries, due to tax implications of liquidation of the banks' deferred reserves. Nevertheless, the four foreign banks with subsidiaries are expected to establish branches for a trial period.

In conclusion, the competitive environment facing U.S. banks has changed substantially since the 1986 National Treatment Study. Where foreign banks found legal and structural restrictions and denials of national treatment in Finnish financial markets at the beginning of the decade, they now face intensified competition with well-established and more cheaply funded Finnish banks. The rapid pace of financial market liberalization, which has yielded market-determined interest rates and almost unrestricted capital flows, has allowed U.S. banks to take advantage of their strengths -- international networks and value-added services in the major financial markets -- in competing for the business of the Finnish corporate sector.

Having refrained from participating in Finland as full-service retail banks, with a labor-intensive branch network, has proved to be a blessing. All of the large indigenous banks are now rationalizing their retail branch networks and reducing personnel levels. Sharper competition, lower lending margins and the increasing share of securities in household savings will further erode bank profits, leaving the U.S. institutions well placed to compete in narrow market segments, such as international finance.

The proposed Branch Bank Act contains a reciprocity provision inspired by the EC Second Banking Directive, which would result in the rejection of applications to establish branches by banks from countries which do not allow Finnish banks to establish branches. It is very unlikely that Finnish regulators would apply the reciprocity provision to U.S. financial institutions.

CONCLUSION

There has been continued improvement and movement toward full national treatment although some constraints remain. Foreign banks were not allowed in Finland prior to 1979; their presence is still very small. Liberalization of Finland's financial markets, underway since 1983, has continued in recent years, with a variety of steps to encourage a market-oriented evolution of Finland's previously limited and tightly controlled financial sector. Deregulation of limits on call market interest rate spreads in 1986, followed by the introduction of CDs in 1987, contributed importantly to a well-functioning interbank money market. Nevertheless, Finland has not been a profitable market for U.S. banks. Pending legislation would permit the establishment of foreign bank branches in 1991 (presently only foreign subsidiaries are permitted); however, this legislation contains a reciprocity establishment provision. In addition, the Government has indicated its unwillingness to permit foreign acquisition of a controlling interest (more than 20 percent) in an established domestic bank.

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*U.S. dollar figures calculated at the following rates:

1988: $1 = markka 4.191 AA
1989: $1 = markka 4.295 AA
1990: $1 = markka 4.0 (March 19, 1990)

AA = Annual Average

12. Finland - Securities

SUMMARY

Finnish securities markets were transformed between 1985 and 1990 from a clubby, relatively narrow industry, emphasizing trading in bonds and debentures, to a full-scale source of equity and debt finance, as well as financial derivatives. The changes were wrought by steady market liberalization at home and abroad, relaxation of capital controls during the period, favorable changes in taxation policy and the evolving needs of Finland's booming, trade-oriented economy.

The stock exchange enjoyed an extended boom for most of the 1980s, finally slumping in 1989. Trading of new equity issues on the exchange during the period outpaced the traditionally larger and more active bond sector as Finnish households added equities to their savings portfolios, and domestic corporations found the equity bull market to be a more cost-effective source of finance.

Finland's large commercial banks, which traditionally dominated the deposit and lending side of financial markets, strengthened their positions in investment banking and securities trading during this period of rapid liberalization and market development. Foreign banking subsidiaries, at present the only permitted form of entry, are entitled to full national treatment in the securities markets. Restrictions limit the ownership of real estate and corporate stock, but those on the latter apply equally to domestic institutions. Both limitations are in flux as Finland prepares new financial market legislation which will continue the progressive liberalization of the economy and anticipate European Community (EC) single market requirements for free movement of capital and services.

Any registered bank, foreign or domestic, may apply for a securities trading license; all commercial banks are permitted to engage in investment banking activities. At present, no U.S. financial institutions operate in Finland's securities markets.

Finland's economic policy agencies (Finance Ministry and Bank of Finland) have expressed their commitment to completing the process of opening and liberalizing the country's financial markets. A key factor has been negotiations between the European Free Trade Area (EFTA) and the European Community regarding the creation of the European Economic Space and the anticipation of EC demands for reciprocity embodied in the Second Banking Derivative.

Legislation is pending that would permit the establishment of foreign branches, possibly as early as 1991, which would be allowed to engage in securities market transactions on the same basis as commercial banks. The proposed legislation includes a reciprocity provision which would allow rejection of branch applications from foreign firms whose parent countries have refused a branch application from a Finnish firm.

There has been significant improvement toward full national treatment.

OVERVIEW

Domestic Securities Market

The Finnish securities market today bears little relationship to the small scale, low turnover operation of ten years ago. The stock and bond markets have increased dramatically in volume and offer a wide range of securities products. The market value of all traded securities in 1988 was markka 352.0 billion ($84 billion)*, versus markka 24.2 billion ($6.5 billion) in 1980. This quantitative leap in activity was accompanied by a structural transformation. The market evolved from one which had a relatively low share of securities in household savings (banks intermediated tax-free deposits for corporate finance) to one which offered a diversified, sophisticated range of savings and corporate finance choices. This transformation resulted from deregulation and was accompanied by the emergence of market-determined interest rates and a formal money market. In response to the rapid growth in securities trading, new legislation came into force in 1989, which established the Bank Inspectorate as the sector's regulatory body. Finland's first rules on insider trading were also included.

Finnish financial markets consist primarily of markets for medium and long-term debt, although the equity market has also become an important source of business finance. Futures and options have also emerged as useful financial tools. In particular, the corporate bond market has deepened and diversified with major issues quoted on the stock exchange and traded directly between large institutional investors. The creation of a formal money market in 1987-88 led to greater use of such short-term financial instruments as certificates of deposit (CDs), commercial paper, bank drafts and bills. CDs have become a significant source of bank funding, with the domestic market interest rate, Helibor, tracking Euromarket rates.

Relaxation of capital and foreign exchange controls have permitted Finnish corporations direct access to offshore financial markets, both for raising equity capital and for floating bonds and commercial paper programs. This in turn has created competition for Finnish domestic financial markets.

Equity Sector: Stocks are quoted on the Helsinki Stock Exchange (HSE), established in 1912, on an over-the-counter (OTC) list and on a brokers' list. Total HSE turnover in 1989 was markka 40.4 billion ($9.4 billion) with total market value markka 129.7 billion ($30.2 billion) at the end of 1989. New issues in 1988 totalled markka 8.4 billion ($2.0 billion) compared to a modest markka 373 million ($100 million) in 1980. The OTC and brokers' lists consist of 55 and 27 non-HSE listed firms, respectively. The lists are maintained by the Finnish Stockbrokers' Association. While an estimated 30 percent of Finnish households hold stock, approximately 70 percent of publicly quoted corporate stock is held by institutional investors, reflecting tax advantages of corporate stock ownership. Finnish securities and banking law permits appropriately licensed banks to engage in investment banking and brokerage; thus the major commercial and savings banks feature prominently among the 23 registered HSE securities trading firms.

Bonds: The bond market, which is formally conducted on the HSE is undergoing structural transformation as bonds are increasingly traded directly between institutional investors outside the HSE. Larger in volume than the equity market, new bond issues in 1988 reached markka 15.7 billion ($3.75 billion) pushing the total amount outstanding to markka 100.6 billion ($24 billion). The sector, however, has stagnated. Tax-free issues are being reduced as the Government seeks to apply uniform treatment in the taxation of capital income. With the corresponding upswing of taxable issues, the market has diversified its products, which now include convertible bonds and bonds with equity warrants. For the first time, in 1986, the volume of stocks traded on the exchange exceeded that of bonds. In 1989, bonds accounted for only 15 percent of turnover on the HSE (although this was due primarily to an increasing number of bonds trading outside the bourse). In 1985, this figure was 85 percent. The breakdown of bond issuers is: financial institutions, 44 percent; government, 33 percent; and corporations, 20 percent. Sales of long-term markka-denominated bonds abroad, which were prohibited in 1985, were recently liberalized for issues starting in February 1990.

Futures and Options Markets: The legislative basis for standardized trading in options and futures was laid in 1988. Subsequently, the Finnish Options Market, Ltd. (FOM) was established. Turnover in futures and options trading in 1989 was markka 1.37 billion ($320 million), with options trading accounting for the majority of market activity. An active interbank market in interest rate forward contracts also exists.

Mutual Funds: This is a new market sector, which started in 1987 on the basis of a new law. Mutual funds must be operated by specially licensed corporations. They may not engage in any other activities, and for the most part have been established by banks. In 1989, there were six such funds, which posted disappointing results due to a declining stock market and lack of investor interest.

Regulatory Authority: The Securities Act of 1989 made the Banking Supervision office the regulatory authority for securities markets. The Bank Inspectorate supervises rules on disclosure, insider trading and other features of the act.

U.S. Presence in the Market

Any registered bank, whether foreign or domestically owned, may apply for a securities trading license to operate on the Helsinki Stock Exchange. Currently, there is one foreign banking subsidiary active in the market. All commercial banks are permitted to engage in investment banking activities, such as underwriting and securities trading.

One U.S. banking subsidiary held a license and participated in the securities market, enjoying national treatment in all areas. (Any securities-licensed firm, domestic or foreign, however, is subject to a 10 percent ownership restriction of nonfinancial corporate voting stock.) The U.S. subsidiary sold its securities unit in 1989 as part of a shift in global strategy by the parent institution.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

At present, a U.S. bank may enter the securities market only by establishing a commercial banking subsidiary, which requires approval of both the Ministry of Finance and the State Council. The subsidiary must subsequently apply for a securities trading license, which is required for membership in the Helsinki Stock Exchange.

Provisions of a new banking law (expected to be passed in early 1991) may make it possible for a U.S. financial institution to establish or acquire a securities trading company, without going through the intermediate step of setting up a subsidiary bank. It appears that branch establishment will also be possible in the near future, with foreign branches allowed to engage in securities markets transactions on the same basis as commercial banks. However, the legislation providing for foreign branch establishment does contain a reciprocity provision which provides for Finnish rejection of branch applications from foreign firms whose parent countries have refused a branch application from a Finnish firm.

At present, there are no U.S. interests operating in the Finnish securities market. The experience of the one U.S. subsidiary which operated through 1989 was that there were no substantial denials of national treatment. Finnish law provides for foreign subsidiaries to be accorded treatment as full-fledged Finnish institutions.

CONCLUSION

There has been significant improvement toward full national treatment. Substantial liberalization of securities markets has occurred in recent years. Regulatory changes in 1987-88 opened the way for CDs, commercial paper and mutual funds; relaxation of capital and foreign exchange controls opened access to foreign capital markets, and sharpened domestic competition. Any registered bank, foreign or domestic, may apply for a securities trading license. Pending legislation would permit direct foreign establishment of a securities firm, without the current intermediate step of establishing a Finnish banking subsidiary. The same legislation would also permit foreign branch establishment, subject, however, to a reciprocity provision.

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*U.S. dollar figures calculated at the following rates:

1980: $1 = markka 3.730 AA
1988: $1 = markka 4.191 AA
1989: $1 = markka 4.295 AA

AA = Annual Average

13. India - Banking

SUMMARY

India's banking industry is largely owned and operated by the Government. The State Bank of India and its subsidiaries, 20 formerly private banks nationalized in the 1970s and early 1980s, and small regional rural banks account for 92 percent of all bank branches and an estimated 90 percent of all banking activity. Indian private banks own 7.4 percent of all branches, but handle under 6 percent of banking transactions. There are 21 foreign banks operating in India with 136 branch offices, handling just over 3 percent of India's banking business. In addition, six foreign banks with representative offices handle overseas transactions but are not active in the domestic market. Most foreign banks were established prior to India's independence in 1948. Citibank, Bank of America and American Express operate banks in India that are leaders in consumer banking services, factoring and mobilization of foreign currency deposits by nonresident Indians.

All banking activities are governed by the Reserve Bank of India (RBI) under the Banking Regulation Act of 1949 (amended 1983) and, in the case of foreign banks, by the Foreign Exchange Regulation Act of 1973. Entry of foreign banks is conditional upon "reciprocity" in the foreign bank's country of origin, defined to mean that the number of banks and bank branches allowed in India is no greater than the number of Indian banks and branches in the country of origin. However, India's state-owned banks find it difficult to compete abroad and therefore have few overseas offices. This restricts entry and expansion of foreign banks in India.

Once in the market, foreign banks receive *de jure* national treatment under the Banking Regulation Act. In practice, the foreign banks receive better than national treatment in some areas and less than national treatment in others. For example, foreign banks are required to devote only 15 percent of lending to government-determined priority sectors, while 40 percent of all other banks' lending must go to priority sectors. On the other hand, foreign banks are severely restricted in the number of branches they may have, while domestic banks are encouraged to open new

branches. Nonetheless, foreign banks have found the market to be quite profitable, since the state-owned banks are not particularly competitive or innovative. Despite their small numbers and restrictions on their operations, foreign bank profits accounted for over 20 percent of total bank profits in 1989.

Nevertheless, significant denials of national treatment remain with no improvement.

As of year-end 1989, three U.S. banks operated 11 branches with assets of $2.5 billion and one subsidiary with assets of $6 million in India. Although a net decrease of two branches, this presence represents an increase of $1.5 billion in assets since year-end 1985. At that time, three U.S. financial companies operated a total of 13 branches in India with assets of over $1 billion. Another five U.S. banks maintained representative offices in India.

At the end of 1989, three Indian banks operated two agencies with assets of $182 million, six branches with assets of $551 million, and one subsidiary with assets of $26.4 million in the United States. One Indian bank maintains a representative office in the United States. This presence represents a decrease of one subsidiary, but a net increase in Indian-bank controlled assets of $91.4 million since year-end 1985. At that time, three Indian banks operated six branches, two agencies and one representative office in the United States with total assets of $407 million. In addition, Indian individuals and companies reported majority interests in two U.S. chartered banks with a total of five branches and aggregate U.S. assets of $79 billion.

OVERVIEW

Domestic Banking Market

The Indian banking industry is dominated by the government-owned State Bank of India and its subsidiaries, some 20 formerly private banks which were nationalized in the 1970s and early 1980s and a host of small rural regionally based banks. These government-owned banks account for 92 percent of all bank branches and 90 percent of banking activity. Private domestic banks, many of them also regionally based, have 7.4 percent of all branches and handle just under 6 percent of banking activity. There are 21 foreign banks with permission to operate branches in the

Indian market and six other foreign banks with representative offices handling mostly overseas transactions. Foreign banks have only one-fifth of one percent of all branch offices, but they handle over 3 percent of domestic banking business and account for 20 percent of total banking profits.

Aggregate bank deposits as of end-January 1990 totalled 1.621 trillion rupees ($95.5 billion). Gross bank credit amounted to 964.4 billion rupees ($56.8 billion), yielding a loan/deposit ratio of about 60 percent. The following table lists major public sector banks and gives the latest (1987) firm information on the number of branches, amount of deposits, and amount of loans (in billions of rupees):

Bank	Branches	Deposits	Loans
State Bank of India	7,537	292.3	206.8
Bank of India	1,950	105.3	63.6
Punjab Nat'l Bank	2,561	93.0	44.0
Bank of Baroda	1,976	85.8	46.7
Central Bank of India	2,569	82.4	38.5
Canara Bank	1,863	78.8	46.6
Syndicate Bank	1,441	52.1	31.4
United Comm'l Bank	1,731	54.6	27.5
Indian Overseas Bank	1,096	46.5	27.3
Indian Bank	1,126	44.6	25.9
Union Bank of India	1,668	43.6	20.3
United Bank of India	1,092	33.9	16.0
Allahabad Bank	1,389	32.6	12.7
Bank of Maharashtra	1,003	25.7	11.3
Dena Bank	1,014	23.6	11.5
State Bank of Patiala	534	19.9	8.0
Punjab/Sind Bank	650	17.6	8.2
Vijaya Bank	680	16.7	9.2
State Bank of Binaner and Jaipur	638	16.5	9.0
State Bank of Hyderabad	639	14.2	8.4
Oriental Bank of Commerce	487	15.4	7.2
New Bank of India	564	15.2	7.7
State Bank of Travancore	589	14.0	9.0
Corporation Bank	411	11.3	5.9
State Bank of Mysore	461	10.9	6.5
State Bank of Saurashtra	303	7.8	4.1
State Bank of Indore	284	8.3	5.0
Total	36,256	1,263.0	718.3

In addition to the 27 major public sector banks listed above, there are some 227 small private and public sector banks scattered throughout India. The volume of business handled by these regionally oriented banks is less than 10 percent of total banking activity; data on these banks is limited.

Foreign bank entry and activity is regulated by the Reserve Bank of India (RBI), under the Banking Regulation Act of 1949 as amended in 1983, and the Foreign Exchange Regulation Act of 1973. The Banking Regulation Act, Section 22.3A, requires that foreign banks be licensed by the Reserve Bank of India (RBI), subject to whatever conditions the RBI may see fit to impose. These conditions may change from case to case, but as a general rule, the RBI requires that Indian banks be operating in the country in which the foreign bank has its home office, that the operations of the foreign bank in India serve the public interest and that the RBI be allowed to examine the books of the foreign banking company prior to issuing the license. Foreign banks are allowed the same number of banks and branches as Indian banks have in the banks' country of origin. The Reserve Bank weakens this reciprocity condition on a selective basis, since Indian banks are often unwilling or unable to compete in many of the countries which have banking operations in India. The Reserve Bank implements its regulatory authority through periodic issuance of an exchange control manual and occasional administrative circulars.

There are 27 foreign banks represented in India, with 136 branch offices. Six foreign banks have only representative offices, which are restricted to external trade and foreign investment transactions. Banks are generally not allowed to have both representative offices and local branches, although there have been some recent exceptions to this rule. The 21 foreign bank branches, most of which have been in India since before 1948, undertake a full range of commercial banking operations. Some of these banks have also set up merchant banking divisions, offices abroad for mobilizing special deposits by nonresident Indians (NRIs), securities operations, and management consultant services.

The following table gives a summary of the latest available data (1987) on foreign banking operations in India, including number of branches, amount of deposits, and amount of loans (in billions of rupees):

Banks	Branches	Deposits	Loans
Grindlays Bank PLC	56	12.1	6.0
Citibank N.A.	6	6.2	4.1
Hongkong and Shanghai Banking Corp.	20	5.9	3.4
Standard Chartered	24	4.1	2.5
Bank of Credit and Commerce Int'l.	1	2.8	2.1
American Express Bank	3	2.5	1.7
Bank of America	4	2.3	2.8
Bank of Tokyo Ltd.	3	1.6	1.3
British Bank of the Middle East	1	1.4	0.9
Banque Nationale de Paris	5	1.2	0.8
Algemeine Bank Netherland N.V.	3	0.6	0.4
Banque Indosuez	1	0.6	2.6
Deutsche Asian Bank	1	0.5	0.3
Bank of Oman Ltd.	1	0.5	0.3
Societe Generale	1	0.4	0.6
Oman Int'l. Bank	1	0.3	0.2
Abu Dhabi Commercial Bank Ltd.	1	0.2	0.1
Mitsui Bank Ltd.	1	0.2	0.1
Bank of Nova Scotia	1	0.2	0.1
Sonali Bank	1	0.1	0.0
Bank of Bahrain and Kuwait B.S.C.	1	0.0	0.0
Total	136	35.5	30.3

Foreign banks accounted for 0.2 percent of total bank branches, 3.1 percent of deposits, 3.6 percent of loans and 20 percent of total bank profits in 1987. Foreign bank profits were equivalent to 32 percent of the profits of all government-owned banks. Profitability of the public sector banks is limited by overstaffing and an excessive branch network mandated by the Central Government. Deposits per employee averaged 3.7 million rupees ($285,000) for the foreign banks as compared to 1.7 million rupees ($131,000) for the public sector. Deposits per branch averaged 35 million rupees ($2.7 million) for the public sector banks and 207 million rupees ($16.0 million) for foreign banks. Foreign banks are also growing more rapidly than public sector banks. In 1988, foreign bank deposits grew by 30 percent, while deposits in public sector banks increased by only 19.3 percent. Those foreign banks which have been permitted to enter the Indian market are very competitive.

U.S. Presence in the Market

Three U.S. financial institutions operate a total of 11 branches in banking in India. Citibank's branches have deposits of 6.4 billion rupees ($368.2 million); American Express Bank's branches have deposits of 2.5 billion rupees ($143.8 million); and Bank of America's branches have deposits of 2.3 billion rupees ($132.3 million). The U.S.-owned banks are leaders in consumer banking, factoring and other "high-tech" banking services (Citibank even has a computer software operation) and are among the most profitable foreign banks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

While entry of foreign banks is restricted by the reciprocity condition, once in the market they receive *de jure* national treatment under the Banking Regulation Act. In practice, branches of foreign banks have received better than national treatment in some areas and less than national treatment in others. Foreign banks are not required to open branches in rural areas, while domestic banks are encouraged to do so (this is seen as an advantage by most foreign banks, including the three U.S. banks, because the smaller rural branches are considerably less profitable).

Until 1989, foreign banks were not required to make loans in support of the Government of India's development priorities, while all domestic banks are forced to place 40 percent of loaned funds in government-determined priority sectors. In March 1989, the Reserve Bank notified foreign banks that they would have to place 10 percent of lending in the priority sectors in 1989/90 (Indian fiscal year, April-March), 15 percent in 1990/91, and 20 percent beginning in 1991/92. Finally, foreign banks have traditionally operated from a very small capital base, while the Reserve Bank has been forcing domestic banks to increase their capital in order to improve their image on international markets. In 1989, however, the RBI instructed all foreign banks to raise their capital to 4 percent (from 2-3 percent at present) of total assets.

Restrictions on Opening of Branch and Representative Offices: The Reserve Bank fixes the number of authorized branches upon granting the entry license, and does not usually allow foreign banks to have both representative and branch offices. The restriction on the number of branches applies only to foreign banks, and limits their ability to provide banking services. For example, a U.S. bank which handles accounts receivable collection would like to open several one-person offices to speed processing of this service. Similarly, a U.S. bank with extensive credit card operations would like to open a number of regional processing centers to handle its credit card accounts. Under current practice, for each such office that these banks open in India, they must close one of their branch offices. These arbitrary and rigid restrictions limit the ability of U.S. banks to expand and develop new services for the Indian market.

Inability to Do Business with Public Sector Firms: The Ministry of Finance occasionally issues instructions to public sector companies to do business only with public sector banks. While there are some exceptions, especially in trade finance, past efforts by U.S. banks to take advantage of them have resulted in closure of such loopholes shortly after service to the public sector firm has begun. Further efforts by U.S. banks to do business with public sector companies generally result in a phone call or written inquiry from the Reserve Bank as to the U.S. bank's intention. Such restrictions are not universal, however, and U.S. banks serve many of the larger public sector firms, including the Oil and Natural Gas Commission (ONGC).

Definition of Capital Base: The RBI defines the capital base of a foreign bank as 3.5 percent of aggregate liabilities. In theory, no foreign bank may lend more than 25 percent of this narrowly defined capital base to any one borrower, or more than 50 percent of this amount to any single industrial group, although the RBI was not enforcing this rule as of mid-1990. Public sector banks, on the other hand, have an unlimited capital base, since their capital is underwritten by the Government of India. Therefore, this lending restriction does not affect them in the same way it may affect foreign banks. For example, the Government increased total paid up capital of the State Bank of India by one billion rupees ($77.1 million) in 1987 and transferred another two billion rupees ($154.3 million) to the other public sector banks, thereby permitting them to lend larger amounts to a single client.

Other Lending Requirements: As noted above, since May 1989, foreign banks have been required to ensure that 10 percent of total lending is in support of priority development activities as determined by the Central Government. This requirement has gone up to 15 percent for 1990/91 and will reach 20 percent in 1991/92. This is well below the 40 percent required of domestic banks, and as such is better than national treatment. It represents, however, an increase in RBI restrictions on foreign banks, which had previously been totally exempt from this requirement. In the same May 1989 circular, the Reserve Bank imposed a requirement that 3.5 percent of total assets be lent to Indian borrowers in hard currency. Foreign banks have objected that this requirement forces them to increase hard currency lending well beyond the interbank lending already being done. As of mid-1990, this requirement was not being enforced.

Other Operational Restrictions: Section II of the Banking Regulation Act stipulates that all banks must retain in India an amount equivalent to 20 percent of total annual profits from Indian operations. The Act does not specify the currency in which cash holdings must be denominated, but the RBI requires that holdings be in rupees. In March 1989, the RBI issued a circular requiring that foreign banks retain in Indian books a separate reserve account of another 20 percent of annual profits from Indian operations. The RBI has not granted permission to take forward cover either on permanent capital nor retained profits. This limits the ability of foreign banks to hedge against rupee depreciation. For exchange control purposes no bank, foreign or domestic, is permitted overdrafts to correspondent banks.

The entry and branch expansion restrictions deny U.S. banks national treatment. The other restrictions noted have more to do with the Indian Government's policy to favor the public sector over the private sector, whether foreign or domestic. The three U.S. banks currently operating in India are profitable and have not recently encountered serious difficulty in repatriating profits, although delays in obtaining timely RBI clearance have been troublesome in the past.

CONCLUSION

No improvement: significant denials of national treatment exist. Restrictions remain on entry and expansion of foreign banks. The number of foreign banks and bank branches allowed in India may be no greater than the number of Indian banks and branches which exist in that foreign country. Since India's state-owned banks find it difficult to compete abroad and therefore have few offices, reciprocity limits new entry and the expansion of U.S. and other foreign banks in India. Once in the market, however, foreign banks receive better than national treatment in some areas and less than national treatment in others. For example, foreign banks are only required to devote 15 percent of lending to government-determined priority sectors in contrast to 40 percent of all other bank lending. As noted, however, foreign banks are severely restricted in the number of branches they may have, while domestic banks are encouraged to open new branches. Nevertheless, once in the market, a foreign bank reportedly finds it profitable.

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*U.S. dollar figures calculated at the following rates:

1987: $1 = 12.962 rupee AA
1990: $1 = 16.966 rupee (end-January 1990)
$1 = 17.38 rupee (June 1, 1990)

AA = Annual Average

14. India - Securities

SUMMARY

The Indian equity and bond markets are largely closed to overseas investors, except for stocks issued in formation of joint venture firms. Indian stocks are not listed or traded in overseas markets, and foreign brokers or buyers cannot operate directly in Indian markets. Indirect access to Indian capital markets is possible through two mutual funds which have been floated by the Unit Trust of India (UTI) on the New York and London Exchanges. (The New York Fund is managed by Merrill Lynch.)

Foreign banks were permitted to engage in merchant banking in 1969. The main services offered by merchant bankers are issue management, loan syndication, portfolio and funds management, project advisory services, private placements of securities, mergers and acquisitions, aiding foreign collaborations in joint ventures and other traditional merchant banking activities.

Foreign firms are able to purchase tax-exempt public sector debentures as a hedge against tax liability, but are not major players in the debentures market. Foreign firms provide many merchant banking services, and are particularly active in portfolio management, investment counseling, issue and funds management and private securities placement. In addition, inward investment by nonresident Indians (NRIs) has been liberalized since 1986. Firms which are at least 60 percent NRI-owned may now invest in shares and debentures through primary or secondary markets.

Finally, the Government of India is preparing legislation to provide a legal framework for the Securities and Exchange Board of India (SEBI) which will centralize most regulation of stock exchanges and merchant banking activity. The SEBI was constituted in 1988 to assist the government in the healthy and orderly development of capital markets and to ensure protection for investors.

As noted above, Indian capital markets are, for the most part, closed to foreign investors. Major denials of national treatment exist and no significant improvements have been made.

OVERVIEW

Domestic Securities Markets

The first stock exchange in India was set up in Bombay in 1875. The Bombay Exchange (BSE) is still the largest exchange in India both in terms of market capitalization of listed stocks and average daily turnover. There are numerous other recognized exchanges, such as those in Calcutta, Madras and Delhi. The exchanges are independent bodies with autonomous constitutions and governing boards. They work under the supervision of the stock exchange division of the Ministry of Finance.

Primary Securities Markets: Indian capital markets grew rapidly in the 1980s. Approvals for capital issues, shares, debentures and Public Sector Unit (PSU) bonds increased more than tenfold from 7.8 billion rupees ($900.8 million)* in 1981 to 81.2 billion rupees ($5.8 billion) in 1988. Debenture approvals for government companies, largely on account of PSU bonds, showed the most rapid growth, increasing from just under two billion rupees ($176 million) in 1984 to nearly 32 billion rupees ($2.3 billion) in 1988. Resources raised from capital markets through the issue of shares, debentures and bonds grew from six billion rupees ($693 million) in 1981 to 56 billion rupees ($4.0 billion) in 1988, showing an average compounded growth rate of 38 percent per annum.

In the private sector, both equity and debentures have been increasing in importance, while preferred stock is relatively little used. The most important factor accounting for the increasing popularity of equity among the investing public has been the buoyancy of the secondary capital markets. This buoyancy has been encouraged by government policies, including increased tax exemption limits for dividends, a shorter holding period for tax concessions on long-term capital gains, liberalization of bank lending against corporate securities and a general trend toward industrial liberalization. While tax concessions have been tightened slightly under the 1990/91 budget proposal, gradual liberalization of industry and of capital markets is expected to continue.

Debentures have emerged as one of the key sources of long-term financing, although there was a sharp drop in debenture issues in 1989/90. There is strong market preference for convertible debentures, since they hold the promise of obtaining equity shares at attractive prices. Public Sector Unit bonds have also been popular, and have been a major source of financing for railways, power and telecommunications. PSU bonds carry interest rates of 9-10 percent and are fully exempt from income or wealth taxes. This differential tax treatment for PSU bonds has been criticized as unfair competition for resources, and is largely responsible for the drop in debenture financing in 1988/89.

Regulatory Authorities: The primary market is governed by the Capital Issues Control Act of 1947 (CICA), which is administered by the Controller of Capital Issues (CCI) in the Ministry of Finance. The secondary markets are regulated according to the Securities Contracts Regulation Act of 1956 (SCRA). This Act describes the procedure for recognizing stock exchanges and gives the requirements for listing securities. This Act is administered by the stock exchange division of the Ministry of Finance. In addition, several clauses of the Companies Act of 1956 pertain to issuance and trading of securities by public and private firms. The Securities and Exchange Board (SEBI) was established in 1988 to assist the government in the healthy and orderly development of capital markets and to ensure protection for investors. Legislation is being prepared to make the SEBI a statutory body.

Secondary Markets: There are 19 stock exchanges in India recognized under the Securities Contracts Regulation Act of 1956.

The Bombay exchange, set up in 1875, is the oldest and largest exchange, accounting for over two-thirds of all listed issues as well as secondary market trading of corporate securities. The five largest exchanges -- Bombay, Delhi, Calcutta, Madras and Ahmedabad -- account for over 90 percent of secondary market trading. The following table provides data on the 16 exchanges, with capitalization expressed in billions of rupees, as of December 1987:

Exchange	Companies Listed	Stocks Listed	Equity	Debentures and Bonds	Total Market Capitalization
Bombay	2,095	3,579	219.8	79.6	300.2
Delhi	1,816	2,371	115.6	44.6	160.8
Calcutta	2,073	2,719	106.5	25.6	132.8
Ahmedabad	584	1,026	82.1	41.4	123.7
Madras	529	975	63.1	28.9	92.4
Bangalore	266	431	50.7	29.0	80.0
Kanpur	732	784	30.7	29.3	60.0
Pune	82	82	36.6	0.5	37.1
Cochin	65	133	29.4	7.5	37.0
Hyderaba	175	257	9.8	4.7	14.5
Indore	96	119	7.3	0.5	7.8
Patna	5	5	5.5	0.0	5.5
Ludhiana	62	63	4.8	0.0	4.8
Gauhati	42	42	3.0	0.0	3.0
TOTAL	5,560	7,696	265.1	88.5	355.2

Note: Total market capitalization equals equity plus debentures/bonds plus the value of preferred shares. (Data were not available for the Mangalore Stock Exchange.)

Securities are traded on stock exchanges through licensed brokers. Settlement periods are generally 14 days. Total market capitalization increased from 67.5 billion rupees ($8.6 billion) in 1980 to 355.2 billion rupees ($27.6 billion) as of December 1987. While the market value of debentures and bonds has been fluctuating around its paid-up value, market capitalization of shares has been increasing more rapidly than paid-up capital. While firm figures for 1988 and 1989 are not yet available, there have been substantial increases in market capitalization of shares, and total value has probably surpassed the 420 billion rupee ($24.2 billion) mark.

Market capitalization is estimated at 15 percent of gross national product, and the share held by the ten largest stocks is estimated at 23 percent. According to the Securities Exchange Board of India, about 90 percent of the trading activity on most of the country's stock exchanges is primarily speculative. A number of regulatory measures have been introduced to prevent excessive share price volatility, including restriction on forward sales and purchases, monitoring of speculative activities and fixing of price bands. When prices exceed the fixed boundaries, state-owned financial institutions (development banks and insurance companies) are requested to intervene in the market.

The stock exchanges have recently begun an effort to encourage floor trading of debentures and other bonds. The government-owned banks have also improved the liquidity of these securities by providing an over-the-counter market for bonds. To improve liquidity for odd-lot shares, the government-owned General Insurance Corporation (GIC) of India has introduced an odd-lot purchase program by which odd-lots of selected shares can be directly purchased from GIC counters in Bombay, Calcutta, Delhi and Madras.

Rapid growth in the securities market has prompted government and industry to develop a number of new supporting institutions and programs. As noted previously, the SEBI is being given regulatory functions. The financial institutions established the Credit Rating and Information Services of India Ltd. (CRISIL) to rate the debt obligations of Indian companies. CRISIL rates debentures, fixed deposit programs, short-term instruments and preference shares. Deregulation of money market rates in 1989 and the introduction of a number of new debt instruments have greatly increased the significance and scope of CRISIL's activities.

Procedures for registration of securities ownership transfers have been cumbersome, creating hardship for the investor. Laws have been changed to provide freer transferability of shares. The validity period of transfer forms has been increased from two to 12 months. Most importantly, Indian financial institutions established the Stock Holding Corporation of India Ltd. (SHCIL) in 1988 to provide clearing and depository services, management information and related support. SHCIL is presently serving only the state-owned financial institutions, but its services will eventually be expanded to other banks, investment firms, mutual funds and individual investors.

U.S. Presence in the Market

Merchant Banking: There are no foreign securities companies established in India. Merchant banking services, similar to investment banking activities in the United States, were first offered by foreign banks in 1969. Since the early 1970s, the public financial institutions have become major players in merchant banking. The Banking and Regulation Act was amended in 1983 to allow commercial banks to create merchant banking subsidiaries, and a number of the state-owned banks (in particular, State Bank of India and Canara Bank) have done well in the merchant banking market. There are three types of merchant bankers:

- Public financial institutions such as the Industrial Credit and Investments Corporation of India (ICICI) and the International Finance Corporation of India (IFCI).
- Commercial banks such as State Bank of India, Canara Bank, and the Merchant Banking Wings of Grindlays, Citibank, Standard Chartered, etc.
- Private nonbank firms like JM Financial and Investment Consultancy Services, Champaklal Investment and Financial Consultancy, and DSP Financial Consultants.

Merchant bankers handle issue management, loan syndication, portfolio and funds management, project advisory services, private placement of securities, arrangement of takeovers or mergers, investment counseling, assistance with intercorporate lending, etc. The merchant banks in India have a much lower level of fiduciary responsibility than their U.S. counterparts and are not subject to statutory control. The SEBI has recommended tightening control over merchant banking to assure bank responsibility at all stages of a merchant banking transaction.

Mutual Funds: Mutual funds are a relatively new development on the Indian market. Prior to 1985, only the state-owned Unit Trust of India (UTI) was allowed to offer units or mutual fund schemes. UTI's funds were popular, but the income and capital appreciation of these funds did not fully reflect the value of the underlying investments. Recently, the State Bank of India (SBI) has launched the India Magnum Fund and Canara Bank, the IS Himalaya Fund. In 1987, the Government allowed public sector banks and financial institutions to launch mutual funds, and amended the tax laws to give concessional treatment to these funds. Foreign firms are not allowed to float mutual funds. Foreign firms do, however, have indirect access to Indian capital markets through two overseas funds launched by UTI: the London Exchange India Fund, and the New York Exchange India Growth Fund. Both are primarily aimed at nonresident Indians, but are freely traded.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Indian capital markets are closed to foreign investors for the most part. Indian stocks are not listed or traded in overseas markets and foreign portfolio investors cannot operate freely in Indian markets. There has been some liberalization of investment in India by nonresident Indians, including the floating of the India Fund and the India Growth Fund. Foreign investment firms which are at least 60 percent owned by NRI investors have been given greater freedom to invest in equities, debentures and bonds. U.S. banks have been allowed to set up overseas funds and other programs to attract NRI investment, but these have not been given the same tax concessions as the government-owned funds.

U.S. banks have been active in merchant banking and other investment support services, but are constrained by the fact that they are permitted only a limited number of branches and are not permitted by the Glass-Steagall Act to trade in foreign securities. Merrill Lynch aided Unit Trust of India in floating the India Growth Fund, and other financial services companies are becoming interested in the Indian market. However, present regulations limit their scope of activity. India's balance of payments deficit and growing external debt will require bold action to encourage inflows of foreign capital into Indian markets. Continued liberalization of the current constraints on foreign involvement in India's capital markets will be essential if those inflows are to take place.

CONCLUSION

Major denials of national treatment exist and no significant improvements have been made. For the most part, Indian capital markets are closed to foreign investors. Indian stocks are not listed or traded in overseas markets and foreign portfolio investors cannot operate freely in Indian markets. U.S. banks have been active in merchant banking and other investment services, but are constrained by the fact that they are permitted only a limited number of branches and are restricted by Glass-Steagall from trading in foreign securities. There has been some liberalization of investment in India by nonresident Indians (NRI), however, including the floating of the India Fund, the India Growth Fund, the India Magnum Fund (SBI/Morgan Stanley) and the IS Himalayan Fund. U.S. banks have been allowed to set up overseas funds and other programs to attract NRI investment, but these have not been given the same tax concessions as the Government-owned funds. Merrill Lynch aided Unit Trust of India in floating the India Growth Fund. Other financial services companies are becoming interested in the Indian market, but present regulations limit their scope of activity.

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*U.S. dollar figures calculated at the following rates:

1980: $1 = 7.863 rupee AA
1981: $1 = 8.659 rupee AA
1984: $1 = 11.363 rupee AA
1987: $1 = 12.877 rupee YE
1988: $1 = 13.917 rupee AA
1990: $1 = 17.38 rupee (June 1, 1990)

AA = Annual Average
YE = Year-End

15. Japan - Banking

SUMMARY

Despite a number of changes in regulations affecting the operations of foreign banks in Japan and the fact that Japan has continued generally to provide *de jure* national treatment for foreign banks (and in a few isolated instances has provided better than national treatment), a number of factors has made access and operating conditions difficult. Foreign banks as a group hold only a minor share of traditional banking business, although they have been more successful in foreign exchange-related and fee-based activities.

The difficulty foreign banks experience in Japan is, in part, due to characteristics which affect the broad spectrum of business in Japan. For example, the strong relationships between members of related groups tend to make it harder for nonmembers, including foreign firms, to penetrate the Japanese market significantly. In particular, foreign banks continue to be at a disadvantage with respect to their domestic competition regarding the cost of their funding, particularly as a result of interest rate controls. In recent years, bank competition has intensified and put additional pressure on loan margins, perhaps making the disadvantage more significant. A series of regulatory changes has significantly reduced the share of bank time deposits still earning low (regulated) interest but has not yet touched "non-time" deposits. This has reduced but not eliminated the foreign banks' disadvantage. In addition, Bank of Japan (BOJ) reliance on direct lending as a tool of monetary policy has given Japanese banks access to substantial quantities of funds at below market rates, which also contributes to the funding advantage they enjoy, on a consolidated basis, compared to their foreign competitors. The lack of transparency in rules and regulations also hampers the operations of foreign banks in Japan.

Liberalization in the money markets has occurred, but Japan still remains behind other major financial centers. One important factor currently influencing the pace of change is the debate over the segmented financial system in Japan, which closely circumscribes the field of activity of participants. The Bank of Japan, with the support of the Ministry of Finance (MOF), is likely to continue efforts to deepen short-term credit markets. The more extensive issuance of short-term Government debt instruments is important in this regard, but expansion of their use remains constrained by tax policies, which reduce their appeal.

Thus, despite modest improvements, a variety of factors have kept the Japanese banking market difficult to penetrate and the slow pace of liberalization and deregulation has provided domestic banks with an unfair competitive advantage over foreign banks both in Japan and globally. These issues as well as the entire spectrum of Japanese banking and securities markets have been addressed in financial market discussions between the U.S. Treasury and the Japanese Ministry of Finance in the "U.S.-Japan Working Group on Financial Markets."

As of year-end 1989, 18 U.S. banks in Japan operated 31 branches with assets of $16.6 billion and 21 subsidiaries with assets of $2.2 billion. Among the 21 subsidiaries are eight offshore securities subsidiaries, six trust companies, three leasing companies and four information/financial services companies. In contrast, U.S. banks operated 30 branches with assets of $17.9 billion and 14 banking subsidiaries with assets of $722 million in Japan as of year-end 1985. Eleven U.S. banks also maintain representative offices in Japan.

At the end of 1989, 41 Japanese banks in the U.S. operated 35 agencies with assets of $54.8 billion, 66 branches with assets of $306.3 billion, and 25 subsidiaries with assets of $59.4 billion. Japanese banks or individuals controlled five Edge corporations with assets of $236.7 million and one New York State Investment Corporation with assets of $15.5 million. Japanese banks maintain 88 representative offices in the United States. Excluding Edge corporations and the New York State Investment Corporation, this presence represents a net increase of 31 operating offices with an increase of $242.6 billion in assets since year-end 1985. At that time, 27 Japanese banks were operating in the United States, through 25 subsidiaries, 70 branches, and 51 representative offices. Their total assets were $177.9 billion.

OVERVIEW

Domestic Banking Market

The Japanese banking market is characterized by its degree of compartmentalization, which limits the scope of business activities for individual types of institutions. The largest banking entities in Japan are found among the 12 city banks; two of these institutions recently merged to form Japan's second largest bank. These institutions have nationwide branch networks and a growing international presence, and they dominate the list of the world's largest banks. They typically have a stable commercial customer base, frequently involving share ownership in their most significant commercial clients. Funding sources have shifted considerably over time for the city banks. In the competition for regulated (low-cost) deposits, the share of city banks has been declining, reflecting the relative sophistication of their depositors. As a result, they have had to look elsewhere to meet some of their funding needs. In particular, they have taken advantage of the increasing diversity of new financial products such as certificates of deposit (CDs) and money market certificates (MMCs). In September 1989, over 70 percent of funds raised by city banks were at partially liberalized interest rates, compared to approximately 50 percent in 1987. In addition, there has been a significant shift in the type of loans and borrowers at city banks. In 1984, for example, over 64 percent of lending had a maturity of one year or less. By the fall of 1989, this share had dropped to 42 percent.

Long-term credit banks, of which there are three, were created decades ago to provide long-term loans to industry. Unlike city banks, their liabilities are primarily long-term, with the bulk coming from the issuance of bank debentures. Only long-term credit banks and four other specialized banks are allowed to issue such debentures, which can have maturities of up to five years. Loans make up the bulk of their assets, but long-term credit banks are also active in government bonds and securities. They have been particularly active as underwriters in the offshore bond market (business precluded to them domestically) and as "commissioned companies" in the domestic corporate bond market.

The 64 so-called first-tier regional banks are also important in Japan, and some are quite large. They have traditionally relied on individual savings deposits but in recent years have moved aggressively to use other means of raising funds, notably through time deposits from corporate customers. Their assets are concentrated in loans, especially to small businesses, but also include domestic securities and foreign assets. The number of such institutions increased significantly in 1989 because of the conversion of 66 of the 68 sogo, or mutual savings and loan, banks into so-called second-tier regional banks. This action more than doubled the number of regional banks.

The 16 trust banks in Japan, of which nine established in the mid-1980s are foreign, plus one city bank licensed to do mostly trust business, have enjoyed the most rapid growth of any of the Japanese banking sectors. This has been partly due to the expansion in the special provinces set aside for them. They and the life insurance companies have in the past been the only institutions allowed to manage corporate pension funds. (As described in the Securities Chapter, amendment of the pension statute in 1989 may moderately increase competition in this area by allowing some investment advisory companies to enter this year on a restricted basis.) In addition, only trust banks have been allowed to offer so-called "tokkin funds" and fund trusts, which offer certain tax advantages to investors. Both of these areas have experienced particularly rapid growth in recent years and have contributed to the enhanced importance of trust banks.

In addition, there are other specialized institutions involved in banking activities. The Norinchukin Bank is owned by agricultural cooperatives and acts as their central bank. The Shoko Chukin Bank provides finance to a nationwide organization of small business cooperatives. These institutions, along with the regional banks, have been important financial intermediaries, serving as net suppliers of funds to other financial institutions through the money markets.

An extremely important element in the overall deposit-taking system in Japan is the postal savings system, which competes with conventional banking institutions for small-saver personal deposits. However, as its funds are deposited in the MOF's trust fund, for later public lending or investment, the system does not compete directly with banks for lending business. Because of its small-saver focus, its support will be critical to the Ministry of Finance's efforts to deregulate small deposits.

Under the Japanese system, only "authorized foreign exchange banks" can do a full foreign exchange business. However, licenses are available to all commercial banking institutions which can demonstrate some expertise in the area. Currently there are 310 such banks, including all the city, first-tier regional, and trust banks, all foreign commercial banks, most second-tier regional institutions, the Norinchukin and Shoko Chukin and some credit associations.

The following table summarizes assets held by various categories of banking institutions in Japan:

Banks in Japan by Type

Japanese Banks:	Number	Total Assets (Yen Billion)
City banks	12	303,726
Long-term credit banks	3	62,305
Trust banks	7	217,217
First-tier regional banks	64	155,799
Second-tier regional banks (Former mutual S&L banks)	66	57,485
Mutual savings\loan banks	2	1,284
Credit associations	454	77,931
Credit cooperatives	414	21,049
Labor credit associations	47	6,999
Agricultural cooperatives	3,688	55,486
Central Cooperative Bank for Agriculture and Forestry	1	32,516
Central Bank for Commercial and Industrial Cooperatives	1	12,185
Foreign Banks:		
Commercial banks	82	21,858
-- of which, U.S.	(18)	(3,917)
Trust banks	9	51
-- of which, U.S.	(6)	(24)

Note: the number of banks as of April 1, 1990; total assets at the end of March 1989.

Progress Since 1986: There have been a number of banking developments since the 1986 National Treatment Study Update was completed. Many of them represent extensions of liberalization measures taken earlier; others are significant changes in approach, including new products and new market segments.

Introduction of Commercial Paper: In November 1987, the Ministry of Finance allowed the issuance of domestic and Euroyen commercial paper. Initially quite restricted in terms of permissible issuers, there has subsequently been a gradual series of liberalizations, which has expanded the number of potential issuers to an estimated 530. (In April 1990, securities firms were also permitted to issue commercial paper (CP) on a limited basis.) This represents a potentially important alternative source of funding for larger Japanese corporations. Both banks and securities companies may act as arrangers, but banks have come to dominate this market of yen 13.1 trillion ($86.5 billion).*

Deposit Deregulation: Interest rate ceilings on "large time deposits" were removed in 1985. However, small time deposits and non-time (less than one month) deposits remain regulated. Prior to April 1987, the minimum size of a large time deposit not subject to interest rate ceilings was yen 300 million ($1.9 million). In several steps, it was reduced to yen 10 million ($69,700), as of October 1989, with a minimum maturity of one month (in the case of CDs, two weeks) in place of the previous 3 months. Large time deposit growth has been dramatic, exceeding in absolute amount the growth of total deposits since the end of 1987. As an intermediate step toward full liberalization of small time deposits, market-linked instruments, called "small money market certificates" (MMCs) were introduced in 1989. Restrictions on MMCs have subsequently been relaxed, effectively lowering the minimum MMC size to yen 1 million ($6,600) in 1990. These instruments, with returns based on market CD or 10-year Japanese Government Bond (JGB) rates, depending on their maturity, have also attracted substantial funds. The MOF in July 1990 announced a three-year timetable for complete deregulation of time deposits but has as yet made no move to deregulate so-called "ordinary" or "non-time" deposits below one month in maturity (accounting for 20-25 percent of total deposits). The three year timetable for interest rate liberalization includes the following initial steps: (1) Two new types of money market certificates (MMCs) with market-linked rates are to be created in November 1990.

These MMCs will have minimum denominations of 1 million yen (roughly $6,600) and 3 million yen ($20,000). The formulation of interest rates on these new instruments will effectively raise the cap on interest paid on MMCs of these denominations. (2) In the Spring of 1991, the minimum amount of small (market-linked) MMCs is to be lowered from 1 million yen (about $6,600) to 500,000 yen (about $3,300). (3) In the fall of 1991, the minimum denomination of market-determined time deposits is to be lowered, from the present 10 million yen (about $66,000) to 3 million yen (about $20,000). A MOF advisory council is currently deliberating moves to deregulate so-called "ordinary" or "non-time" deposits.

Improved Asset/Capital Positions of Banks: In April 1987, banks were permitted to issue domestic convertible bonds for the primary purpose of improving their capital/asset ratios. The restriction on the use of the proceeds was removed in 1990. Except for the long-term credit banks and four other specialized institutions, straight bond issuance by banks remains prohibited. In 1988, for the first time, banks were permitted to engage in limited securitization of their mortgage loans via outright or "repo" sales to trust banks which issue certificates, backed by the mortgages, to institutional investors. In July 1989, sales of loans to municipal governments were launched, followed in March 1990 by permission to sell corporate loans.

Bank Financial Futures Market Formed: In April 1989, the Tokyo International Financial Futures Exchange (TIFFE), limited to bank-related financial futures, was established, with trading commencing at the end of June. Products traded are futures on Euroyen and Eurodollar deposits and the yen/dollar exchange rate. Options on Euroyen interest rate futures may be offered in June 1991. Eight foreign securities companies (all American) are members of the exchange, with seven of the eight having opted for clearing membership. Twelve foreign banks, four from the U.S., have also joined. The foreign bank membership is divided into four clearing members and eight nonclearing members. There are two U.S. banks in each type of membership. Basic capital requirements are very high but were reduced by TIFFE for foreign members to assure a significant degree of participation. Subsequently, in response to foreign bank requests, MOF in December 1989 also eased controls on foreign banks' open futures/options positions to allow for an aggregate ("net") open position against capital for six different products collectively, while continuing to apply the old product-by-product approach to Japanese banks.

Bank of Japan Credit Facilities: Also in December 1989, the Bank of Japan increased foreign banks' access to its direct lending program. Previously, foreign institutions could only borrow against discounted commercial or import settlement bills. The December action accorded them limited access to ordinary loans, at the official discount rate, against deposited collateral, access to which had up to that point been available primarily to the largest city banks and also to long-term credit and other major domestic Japanese banks.

Short-term Money Market: One area of change of significance to foreign banks has been in the "short-term money market," composed of the "interbank market" limited mainly to banks, and the "open market" where other participants (e.g., nonfinancial corporations) are also allowed. Traditionally, interbank borrowing rates were not particularly sensitive to changes in shifts in credit demand and supply. Rather, rates were set daily by interbank brokers ("tanshi companies"), based in part on consultation with the Bank of Japan. In addition, there were limitations on the allowable maturities for both secured and nonsecured borrowings. Foreign banks learned that there were often informal quantitative limits to the lending in this market, even at quoted rates, and that they were not able to deal directly with other banks in bidding for funds. In November 1988, the Bank of Japan announced the first of a number of changes liberalizing operation of the interbank market. These modifications included enlarging substantially the role of the noncollateralized market, expanding maturity ranges, shifting the role of tanshi companies to a more conventional brokerage function with flexibility in market rates, and refocusing the BOJ's own operations from 2- and 3-month bills to new 1- and 2-week bills. As the move unfolded, it became clear that this significant reorientation of the interbank market had begun to allow a greater play of market forces. Earlier, the interbank market had gained an additional channel through the December 1986 opening of a new international banking facility, the Japan Offshore Market (JOM). The JOM has grown steadily since its introduction, with total assets in December 1989 reaching more than $600 billion, roughly split between yen and nonyen currencies. It appears to have assumed the role of principal interbank deposit market, a market which has not been allowed to develop significantly onshore.

In addition, there were some liberalizations in the "open market," including introduction of commercial paper (CP) (noted above) and two reductions in denomination of Japanese "Treasury bills" down to yen 10 million ($66,000) as of April 1990. In January 1989, the Bank of Japan eliminated limits on bank and securities company holdings of domestic CDs for trading purposes. In the yen bankers acceptance (BA) market, there was a reduction in the minimum denomination and extension in the maximum maturity, as well as a reduction in the stamp tax on import bills to a flat yen 200 ($1.30) level from an earlier much more costly rate structure. Nevertheless, due to a combination of market and regulatory factors, the BA market had shrunk to zero by November 1989.

Automated Teller Machines: Japanese banks are this year completing a nationwide network of automated teller machines (ATMs), which allow customers of any of the institutions to have access to a large number of facilities around the country. With almost all sectors of the domestic banking system joining by July 1990, the total number of ATMs in the network will be approximately 60,000.

Conversion of Sogo Banks: In 1989, all but two sogo (mutual savings and loan) banks were converted into commercial banks. Established under a 1951 law, the sogo banks had been prohibited, within certain limits, from lending to large companies. These institutions were regional in character; the vast majority of their liabilities were deposits and the bulk of their assets were business loans. As a result of the conversion, an additional 66 commercial banks with the ability to participate more broadly in banking activities came into being and are known as the second-tier regional banks.

U.S. Presence in the Market

There are 82 foreign commercial banks in Japan, of which 18 are American. All are branches. Most of the growth in the foreign bank presence in Japan occurred in the 1970s and 1980s. At the end of 1970, for example, there were only 18 foreign banks in Japan with a total of 38 branches. The branch network had expanded to 122 by March 1990. The U.S. banks operated a total of 31 branches as of year-end 1989. Despite the numerical increase, foreigners, including those from the U.S., remain very much minor players in the Japanese banking scene and have not generally participated proportionately with their domestic counterparts in the expansion in banking activity. For example, between the third quarters of 1982 and 1989, total deposits of all banks in Japan grew by 143 percent, while those of foreign banks grew by a much smaller 62 percent. The pattern was repeated in more dramatic fashion in lending activity over the same period, which was up 145 percent for all Japanese banks but only 18 percent for foreign institutions. This pattern changed in 1990, when foreign bank lending increased more rapidly than lending by Japanese banks as a result of restrictions imposed on Japanese banks by the BOJ and MOF designed to reduce real estate lending.

In 1985, trust banking was opened up to foreigners, and nine have subsequently entered (one more than the number of Japanese banks doing trust business), including six U.S. institutions. All of the foreign trust banks are subsidiaries. The foreign trust banks have experienced some success in expanding in the "tokkin" and fund trust markets, where their share of the total market is 5.44 percent and 8.5 percent, respectively. However, they have made little headway in the area of pension fund management, where their market share is only 0.17 percent after four years. (Pension fund management is discussed in more detail in the Securities Chapter.) The foreign trust banks have reported profits of yen 3 billion ($23 million) in the Japanese fiscal year ending in March 1989, up 161 percent from the preceding year.

A number of foreign banking entities have been allowed to enter the market with offshore securities subsidiaries. So far 28 such subsidiaries have been established, eight with U.S. parents. In all cases, parent bank ownership is limited to a maximum of 50 percent. In addition, there are physical and operational "firewalls," which separate the operations of the securities affiliate from those of the banking entity in Japan. These securities companies are examples of "better than national treatment," since no domestic bank has been permitted to operate a securities subsidiary in Japan.

In addition, there are 131 representative offices of foreign banking institutions in Japan (of which 11 have U.S. parents). This compares to 71 in 1974. These offices are limited in operation, primarily to observing the market and reporting to their home office. They are not allowed to take deposits or make loans. Most institutions will establish a representative presence prior to applying for a branch license.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Since the early 1980s, the U.S. Treasury and the Japanese Ministry of Finance have been engaged in a series of discussions about financial market conditions and regulation in both countries. Over that time, there has been considerable movement towards liberalization of the Japanese financial structure, although the pace of liberalization has, on the whole, been slow and the process is far from complete. Many of these changes have opened up new opportunities for U.S. entities. In some cases, however, the liberalizations increased competition from the large domestic banks, which possess significant advantages of capitalization, funding, presence and established relationships in the Japanese market.

U.S. banks can establish a presence in Japan via either branches, subsidiaries or representative offices. Physical expansion of branches in Japan is time-consuming because each branch opening requires issuance of a new license. However, Japanese authorities have made efforts to expedite this process. Acquiring an existing Japanese bank is legally possible but extremely difficult because of the cost and pattern of cross-shareholding, which tends to limit the number of shares available for purchase in the market. High stock prices have also acted as a deterrent to even friendly acquisition efforts. Certain provisions of Japanese laws pertaining to antimonopoly, banking, foreign exchange and foreign trade would also have to be met for acquisition to occur. Up to this point, no existing Japanese bank has been acquired by a foreign entity. Article 4.3 of the banking law provides that a reciprocity standard may be applied to foreign banks operating in Japan, relative to what their home governments allow for Japanese banks. The MOF advises, however, that this provision is applied only to the threshold question of establishment, i.e., banks from a country which totally bars entry to Japanese banks would not be allowed to establish in Japan.

As noted in the securities chapter, the MOF is also now prepared to consider licensing branches of offshore, 50 percent-owned bank subsidiaries of securities firms. Some foreign securities firms have seen this as a second-best approach to gaining broader ability to do foreign exchange business. It is not clear how many firms could qualify to use this approach, which is not open to the domestic industry, but four foreign securities companies' subsidiary banks have already established Tokyo representative offices.

As was the case in 1986, foreign banks, including those from the U.S., have a very small presence in Japan, despite the numerous changes in regulations in recent years. In December 1989, their share of total lending dropped to 1.7 percent, down from earlier years. In March 1983, for example, foreign banks accounted for 3.5 percent of total bank lending. In part, the decline in share reflects the relatively rapid growth of domestic lending in the latter 1980s. It also indicates a conscious judgment by the foreign banking community that the highly competitive environment, characterized by low margins on many types of lending, was not potentially profitable enough to justify a significant expenditure of resources in traditional banking areas. Liberalization in the financial area has continued to provide borrowers with increasing choices of alternative means of raising funds, such as commercial paper. This has contributed to heightened pressure on loan margins. Japanese domestic banks have also generally had a base of regulated deposits, on which generally lower than prevailing market interest is paid. This gives them a competitive advantage over foreign firms, which for reasons cited above, do not have a significant domestic branch presence. Loan charges are based in part on the blended costs of funds to domestic institutions, which continue to be below those of foreign banks. Foreign banks have been more successful in foreign exchange dealing and fee-based transactions. (According to one estimate, foreign banks command a 35 percent share of foreign exchange dealing activity in Japan.)

Interest rate controls in Japan, in general, have provided an effective subsidy to Japanese banks and borrowers at the expense of Japanese depositors and foreign banks. To the extent Japanese banks fund themselves with regulated deposits, this subsidy has lowered their average cost of funds, giving Japanese banks a competitive advantage in their home market and, on a consolidated worldwide basis, in markets overseas. This is particularly true since foreign banks, in practice, have not had the option of acquiring a Japanese bank with a large deposit base.

It should be noted that, as controls have been partially relaxed in recent years, the amount of subsidy has lessened; however, it still exists and is considerable. (Japanese depositors lose a substantial sum due to the continued existence of controls on interest payments on deposits which keep rates below what they would be if freely determined; some of this lost interest also benefits borrowers.) While access to deposits at regulated rates has been a factor behind the rapid expansion of Japanese banks' international lending over the past several years, it has not been the only factor. (Others include the large Japanese current account surplus and substantial appreciation of the yen, relatively attractive markets overseas, and a persistent focus on market share.) Nevertheless, domestic interest rate ceilings still reduce the average cost of funds to Japanese banks, which gives them a significant advantage over foreign competitors, enabling them to tolerate narrower margins across a broad range of financial services and transactions.

Since the 1986 Update a series of regulatory changes has reduced the share of bank time deposits still earning low (regulated) interest, but has still not touched more than 40 percent of total bank deposits, including all "non-time" deposits. Until Japanese banks fully compete for all deposits by paying a market rate, Japanese banks will continue to enjoy a government-enforced subsidy at the expense of foreign banks and Japanese depositors. This remains an important factor for foreign banks and other firms, and will continue so until MOF completes deregulation of interest rates by introducing directly market-determined (rather than market-related) interest rates on all deposits, including time, "non-time" and money market certificates.

Domestic banking institutions also benefit from the ability to make more extensive use of the Bank of Japan's credit facilities. This is especially true for city banks, credit lines for nine of which account for over 70 percent, about yen 5 trillion ($33 billion), of total credit lines under BOJ's direct lending program. Since the loans are made at the discount rate, which is below market rates, they provide a relatively cheap source of funds for banks. A ceiling is set on each individual institution's overall access to direct lending. The Bank of Japan has indicated that, in determining a bank's borrowing ceiling, it considers the firm's "business performance and market presence," based in part on the amount of yen lending and reserve requirements. However, foreign institutions have indicated that the basis for the ceiling determination remains vague and, despite the expansion for them in December 1989, appears to favor Japanese city banks.

One of the major problems affecting foreign banking institutions' customer bases in Japan is the difficulty in penetrating group affiliations. Relationships between the banks and borrowers tend to be much closer than in the U.S., and city banks frequently provide the nucleus around which a group relationship is centered. In addition to providing loans to other group members, the banks are frequently assumed to back other group members with an unofficial guarantee. This enhances the credit standing of group members and lowers their cost of capital. While these relationships may provide benefits to all group members, they can also influence purchasing patterns of goods and services in favor of group members, to the disadvantage of nonmembers -- including foreign firms.

It should be noted that despite these advantages, however, the Japanese city banks have also been experiencing significant pressure on operating earnings. Current profit statistics have been relatively robust for the domestic institutions, but this in large part reflects earnings from the sale of equities. For example, operating profits (excluding trading/investment profit or loss) for city banks actually dropped by 21.4 percent in the March-September 1989 period. In addition, the operating profit on total assets for those banks was a small 0.399 percent over the same period.

Liberalization in the money markets has occurred, but despite those efforts and growth in the use of some instruments Japan remains well behind other major financial centers. Foreign banks rely much more heavily than their domestic counterparts on call money and borrowed funds. For this reason, the money markets, and particularly the interbank market, are important in their overall operations. Until November 1988, foreign banks enjoyed privileged access to the uncollateralized call market, as Bank of Japan guidance limited the participation of city banks. Foreign institutions were frequently able to use funds raised in this market to make an arbitrage profit between the controlled (usually lower) interbank rates on yen borrowings and the market determined Euroyen deposit rates. Modifications to the interbank structure, as described previously, made interbank rates more responsive to market forces and removed that arbitrage opportunity. However, the change also significantly reduced the spreads between collateralized and uncollateralized call money. Since domestic banks generally have more collateral than their foreign counterparts, foreign banks had been generally paying considerably more for interbank funds than had domestic institutions, even though less than Euroyen rates. Although these changes had a negative short-run impact on profits of some foreign banks, they represent significant movement toward more market-related interest rates. As business opportunities increase in money markets and interbank markets these changes should eventually produce more favorable conditions for foreign banks.

Foreign banks also find that, on occasion, they have difficulty raising the amount of funds they desire in the interbank market despite a nominal bid/offer system since late 1988 -- because domestic institutions apparently want to limit credit risk from exposure to foreign entities. A number of foreign banks have also argued that their ability to do direct dealing with Japanese institutions, bypassing the tanshi brokers, is highly constrained. BOJ has stated that such possibilities are open, but they appear to the foreign banks to be largely theoretical, not real.

One element that would considerably improve the attractiveness of the money markets would be the establishment of a dependable, liquid market for the Government of Japan short-term Treasury instrument (T-bill). The 18 percent withholding tax, levied on the redemption gain from discounted T-bills, critically dampens interest in the instrument. The withholding tax, which complicates pricing in the T-bill secondary market, serves as a significant deterrent to private sector support for that market. The Bank of Japan is attempting to develop the T-bill market as an arena for open market operations. However, MOF has been taking only incremental steps necessary to develop a large, liquid pool of government paper. To be effective, these steps will have to include not only significantly increasing the frequency and volume of T-bill issues, as MOF is doing, but particularly removing the withholding tax. On the latter point, MOF so far has not taken action.

A continuing concern of foreign banks operating in Japan is the lack of transparency (see also discussion in Securities Chapter). While there is a body of published laws governing the operation of the banking industry, many important regulations or guidances continue to be given orally. This may disproportionately impact foreign firms, which are both less familiar with the unique Japanese environment and more used to dealing with a clear set of written regulations. Although there has been some improvement in their ability to transmit their views to responsible officials since 1986, foreign firms still experience difficulty on occasion in gaining access to Ministry of Finance and industry consultations influencing their operations. This was a particular problem in the formation of the Tokyo International Financial Futures Exchange, where foreign firms had little input in the decision process and were only informed of important specifics on the eve of the exchange's formation. Foreign participants are not included in the official advisory councils, which advise the Ministry of Finance on proposed structural and regulatory changes of central interest to both domestic and foreign financial firms. There are occasionally, however, informal Ministry of Finance study groups where a foreign firm may be included. One of these is the MOF/BOJ study group on money markets, operating since 1989, with three foreign firm members on it.

Another issue relates to the attitude of Japanese banks toward possible inclusion of foreign institutions in their ATM networks. Inability to join such a network could seriously disadvantage foreign institutions seeking to establish a retail banking base. Recently, one U.S. bank reached agreement with the representatives of the twelve Japanese city banks, granting the U.S. bank access to the Japanese city banks' on-line cash dispensing machine (CDM)/automated teller machine (ATM) network called "BANCs." This agreement, which will be effective December 1990, followed two years of protracted negotiations.

U.S. banks continue to face a challenging regulatory and competitive environment in Japan. Since most have chosen to operate at the wholesale level, they stand to benefit disproportionately from completion of domestic bank deposit deregulation, from further liberalization of the Japanese money markets, and from the broadening of business allowed to banking institutions which would likely result from overall financial industry deregulation now under consideration in Japan.

In the meantime, foreign banks' ability to innovate and make appropriate changes in business strategy is frustrated by unfinished deregulation projects and continuing problems of regulatory transparency. Consequently, they are not able to utilize fully their skills in areas in which they have access.

FINANCIAL MARKET DISCUSSIONS

The U.S. Treasury and Japanese Ministry of Finance have been engaged in financial market discussions since 1984. During preparations for the May 1984 "Report on Yen/Dollar Exchange Rate Issues" and in subsequent follow-up discussions, Treasury and MOF officials formally met 15 times. The Report and discussions initially focused on the need to: liberalize Japanese domestic capital markets, primarily by deregulating interest rates and creating an attractive money market; internationalize the yen, primarily by removing restrictions to a freely functioning Euroyen market; and improve foreign firms' access to Japanese financial markets across a range of market sectors. In April 1988, the agenda of the Yen/Dollar Working Group was broadened to include additional U.S. and international issues and the Group was renamed the "U.S.-Japan Working Group on Financial Markets." Although many of the commitments in the 1984 Report have been met, the discussions have continued to address related follow-up issues as well as the entire spectrum of Japanese banking and securities markets and foreign firms access to them.

CONCLUSION

Despite modest improvements, a variety of factors have kept the Japanese banking market difficult to penetrate and the slow pace of liberalization and deregulation has provided domestic banks with an unfair competitive advantage over foreign banks both in Japan and globally. Foreign banks continue to find Japanese markets difficult to penetrate, particularly in traditional banking functions. Japan has continued generally to provide de jure national treatment for foreign banks and in a few isolated instances better than national treatment. However, a number of factors, including regulated interest rates, restrictive operating regulations, strong ties among related firms (keiretsu), excessive compartmentalization of financial markets, and lack of transparency effectively reduce foreign banks' competitive opportunities and in certain cases burden foreign banking firms disproportionately relative to domestic firms.

While Japan continues to liberalize domestic financial markets, the slow pace of reform has failed to keep up with developments in international financial markets. Foreign banks rely more heavily than their domestic counterparts on the domestic money markets for raising funds. While reforms have been made, money markets remain underdeveloped and unattractive due to restrictive regulations, a limited range of permitted instruments, and an array of taxes which encumber virtually every instrument.

Regulated interest rates (affecting roughly 40 percent of total bank deposits) reduce the average cost of funds to Japanese banks, in effect creating a subsidy which, on a consolidated basis, gives them an advantage over foreign banks in the Japanese market and allows them to tolerate narrower profit margins overseas, thus facilitating their expansion in these markets. The substantial amount of BOJ lending to Japanese commercial banks contributes to this funding advantage. Finally, foreign firms have experienced a lack of transparency in the GOJ regulatory process; participation in the rule making process for new products, services and markets is limited and foreign firms are not systematically allowed early opportunity to comment on proposed rules.

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*U.S. dollar figures calculated at the following rates:

1986: $1 = yen 159.1 YE
1989: $1 = yen 143.45 YE; 130.36 (Average March 1989)
1990: $1 = yen 151.39 (June 1, 1990)

YE = Year-End

16. Japan - Securities

SUMMARY

The Japanese securities industry has become one of the world's largest. Equity, debt and derivative markets mushroomed in the late 1980s, while pension fund and investment trust management grew into a multi-hundred-billion dollar industry. The number of foreign securities firms has nearly doubled since October 1986. U.S. firms have taken advantage of a wider range of business opportunities and expanded. Several have become consistently profitable.

Despite these changes, various factors have prevented foreign firms from enjoying a comparable degree of success achieved in other markets. For example, foreign firms have had limited freedom to innovate and offer new products in Japanese markets. Restrictions have prevented securities firms from offering foreign exchange products and services central to their business. Access to domestic underwriting business has been difficult. Japanese investors direct access to foreign markets and products has also been constrained. In other areas where foreign securities firms have considerable talent, such as pension fund and investment trust management, foreign firms are effectively kept on the sidelines despite limited liberalization. In addition, the regulatory system lacks transparency. Despite some improvement, supervisory procedures, regulations and changes in policy are not always accessible in a timely fashion, and foreign firms are frequently left out of informal consultations.

The Ministry of Finance (MOF) espouses a policy of national treatment. It has taken a number of steps to open its markets to foreigners. These include providing greater access to the Tokyo Stock Exchange and Japanese Government bond market and establishing futures and options markets. At the May 1990 meeting of the U.S.-Japan Working Group on Financial Markets, MOF announced measures which could relax some restrictions on introducing new products, accessing overseas markets and offering foreign exchange services. Still, the process of creating a truly level playing field is far from complete. As a result, full and easy access to the Japanese investor base and entire range of securities activities remains difficult.

OVERVIEW

Domestic Securities Markets

Japan's securities markets -- including equities, bonds and derivative products -- have become one of the world's largest. Their size and diversity reflect growth over the past five years in Japanese savings, asset prices, diversified financial instruments and range of sectors and participants.

Equity Markets: The market value of the equity of the 2,019 firms listed on the Tokyo, Osaka, Nagoya and five other Japanese exchanges exceeded Y630 trillion ($4.4 trillion)* by the end of 1989 (although that amount had declined 25 percent by April 1990). Trading volume reached 256 billion shares in 1989, with new equity financing totaling Y8.8 trillion ($63.8 billion). In the registered over-the-counter (OTC) market, an estimated 529 million shares of 279 companies were traded. Nearly 120 foreign companies are listed on the Tokyo exchange. At year-end 1989, outstanding shares were held by corporations (24.9 percent), banks and life insurance companies (42.5 percent), securities firms (2.5 percent), investment trusts (3.1 percent), individuals (22.4 percent) and foreign investors (4.0 percent) with the remaining less than one percent held by government entities.

Debt Markets: Government securities dominate the debt markets. Total domestic issues of Japanese Government bonds (JGBs) in 1989 amounted to Y79 trillion ($572.6 billion). By year-end 1989, bonds outstanding totaled Y317 trillion ($2.2 trillion), of which 58.3 percent were publicly offered central and municipal government bonds and government-guaranteed bonds. Private placements, municipal and public corporation bonds made up another 13.4 percent. Bank debentures accounted for 18.5 percent, corporate bonds 3.2 percent, convertibles 4.9 percent, foreign issued yen bonds 1.6 percent and warrant bonds 0.1 percent. The market for domestic commercial paper of prime corporations, which began in November 1987, grew to Y13.1 trillion ($91.3 billion) outstanding by December 1989.

Futures and Options Markets: In the past three years, the market for derivative products has expanded significantly beyond the original 10-year Japanese Government bonds futures contract launched in October 1985. The Tokyo

International Financial Futures Exchange (TIFFE) opened in June 1989, focusing on "banking" products (e.g., currency and interest rate contracts). Futures and options on stocks, bonds and stock indexes are introduced and traded on existing stock exchanges. The array of domestic contracts includes a 20-year JGB future, futures and options on the Nikkei 225 and TOPIX stock indexes, a new over-the-counter bond options market, and on the TIFFE, Euroyen and Eurodollar (deposit) futures contracts, and yen/dollar (currency) futures contracts. A yen-denominated U.S. Treasury bond futures contract was introduced on the Tokyo Stock Exchange (TSE) in December 1989. Trading activity has been mixed. While some contracts have attracted little interest, others, such as the 10-year JGB futures and Euroyen three-month futures, have exceeded expectations. Most trading centers on: (1) the 10-year JGB futures, with 1989 volume close to Y1,900 trillion ($13.8 trillion); (2) the Nikkei 225 on the Osaka Stock Exchange (OSE) and TOPIX index futures on the TSE with trading volumes in 1989 of Y189 trillion ($1.4 trillion) and Y97 trillion ($703.1 billion), respectively; and (3) the Euroyen three month deposit rate futures on the TIFFE, with volume of approximately Y450 trillion (more than $3 trillion) from its launch in late June 1989 through year-end.

Investment Trust and Pension Funds: The investment trust business (mutual funds directed primarily to retail investors) has also grown rapidly. At year-end 1989, the total reached Y58.6 trillion ($408.5 billion), representing approximately 4,100 individual investment trusts created by 15 licensed domestic investment trust management companies. (Foreign companies were not allowed to be licensed for this activity prior to 1990.) The corporate pension fund business, totaling about Y34 trillion ($224.6 billion), has also expanded. Recent legislation should permit investment advisors (licensed for discretionary funds management), in addition to trust banks and life insurance companies, to manage these funds. To employ investment advisors, pension fund sponsors will be required to obtain a license from the Ministry of Health and Welfare (MHW). Of the roughly 350 eligible fund sponsors (out of a total of approximately 1,200 fund sponsors), 141 had obtained licenses as of July 1990.

Securities Exchanges: Japan has eight licensed securities exchanges, the largest of which are in the major cities of Tokyo (TSE), Osaka (OSE) and Nagoya (NSE). Regular membership is limited to licensed securities firms, although banks may become "special members" of the TSE to participate in government bond and government bond futures and options trading. Securities firms are permitted to join as ordinary or clearing members of the bank-sponsored futures exchange, TIFFE.

Regulatory Framework: Under the Securities Exchange Law (SEL), securities business is reserved for securities companies. The only exception for banks is business pertaining to national and local government bonds, government guaranteed bonds, and futures, options and options on futures on foreign government securities but not the underlying securities. The SEL defines "securities" and provides the framework for Ministry of Finance regulation. Authorizations for dealing, brokering, underwriting and distribution of securities require a specific license from MOF. Occasionally, regulators have allowed securities firms to handle other products (e.g., commercial paper, bankers acceptances, certificates of deposit).

The principal regulatory authority for securities firms' domestic activity is the Securities Bureau of the Ministry of Finance, although the Banking Bureau, the International Finance Bureau and the Bank of Japan have responsibility in some instances. The International Finance Bureau has prime responsibility for offshore activity. Self-regulatory functions are carried out under MOF oversight on the established securities exchanges and in the Japan Securities Dealers Association (JSDA), which administers the over-the-counter equities market.

As of March 1990, firms licensed to do the full range of securities business numbered 96 out of 220 Japanese securities companies, and 47 out of 52 foreign securities firms. The four leading Japanese securities firms are well capitalized (with combined capital of approximately Y400 billion ($2.6 billion), and provide a wide range of securities services both in Japan and abroad, where they may offer more products and services than permitted domestically.

Progress Since 1986: A series of significant measures have been taken since 1986 to open and expand markets. Existing access has been broadened and regulatory practices streamlined. In the Japanese Government bond (JGB) market, foreign firms' shares in the 10-year JGB syndicate were expanded threefold (up to 8 percent) in October 1988. A true price auction for 40 percent of each regular offering of 10-year JGBs was inaugurated in April 1989 (and was increased to 60 percent in October 1990). The Tokyo Stock Exchange admitted 32 new members in 1988 and 1990, including 19 additional foreign firms of which six were American. In the domestic corporate bond market, the list of eligible issuers was expanded, maturities were diversified, private placements were enhanced, bond ratings were introduced and shelf registration for new issues was permitted in October 1988. Risk weighted capital adequacy requirements for securities firms (along the lines of U.S. and U.K. rules) were introduced by MOF in April 1990.

In addition, a variety of new financial instruments were created. These included: a publicly offered 20-year Japanese Government bond in September 1987; domestic and nonresident Euroyen commercial paper (CP) in November 1987; and numerous financial futures and options contracts. Detached yen bond warrants were allowed to be issued domestically in spring 1989. On the other hand, the yen-denominated bankers acceptance (BA), created in 1985, virtually disappeared due to lack of market interest, despite the reduction of the BA stamp tax.

In June 1989, two comprehensive regulatory frameworks were established to govern domestic financial futures and options, one each for "banking" and "securities" products. MOF also made regulatory changes to broaden Japanese investor access to foreign futures and options markets: on June 30, 1989, it allowed licensed banks, securities firms and foreign specialized financial futures/options firms to begin brokering foreign futures and options for Japanese clients. (In 1987 and 1988, some designated Japanese financial institutions were permitted access to listed foreign futures and options for their own account but not for their clients.) In May 1989, a bond lending market was established and short selling of bonds, previously prohibited, was allowed. These changes were aimed at improving the secondary market for Japanese Government bonds. The size of the repurchase ("repo") market has increased but remains constrained by taxation impediments.

U.S. Presence in the Market

Foreign securities firms have proliferated in Japan in recent years. In October 1986, 27 foreign firms (including 13 U.S.-owned) accounted for more than 10 percent of all securities companies in Japan. By March 1990, with 52 foreign firms (including 22 U.S.-owned), the proportion nearly doubled to almost 20 percent. Fifty percent owned offshore subsidiaries of foreign banks were allowed to branch into Japan beginning in late 1985 to engage in securities activities. Twenty-eight foreign banks, including eight U.S. banks, have taken advantage of this liberalization. In addition, 128 foreign securities firms have established representative offices. No foreign firm has established a securities subsidiary, although in 1986 MOF announced that it was prepared to consider subsidiary applications.

Foreign firms have also broadened their activities and deepened their commitment. Profitability has been slow, but generally growing. By mid-1989, U.S. firms were among the largest foreign firms: 11 out of the 19 U.S. firms had more than 100 staff members, and six had more than 200. In the first two quarters of 1989, 10 of the 19 showed pre-tax profits compared to 11 of the 28 non-U.S. firms. By mid-1989, the 47 foreign firms had an average capitalization of Y5.0 billion ($39.4 million); U.S. firms had a higher average of Y7.7 billion ($60.7 million) (although these figures are skewed by two U.S. firms with considerably above-average capital). Some U.S. firms have added substantial capital since March 1989.

By comparison, the top 42 domestic Japanese securities firms in the same six-month period ending March 1989 were all substantially profitable, averaged 2,645 staff per firm, and had Y19.6 billion ($154.5 million) in average capital. For the biggest Japanese firms, those figures were roughly five times larger.

In the past, the primary focus of foreign securities firms' business had centered on the intermediation of international securities transactions, selling foreign securities to Japanese investors or selling Japanese securities to foreigners. More recently, foreign firms have sought to participate competitively in the Japanese debt and equity markets. American firms have become particularly active in the Japanese Government securities market, expanding their clients to include domestic institutional investors. In the first year since the initiation of the partial price auction for 10-year JGBs, one American securities firm was the leading successful bidder among all foreign and domestic firms. Three

American firms were among the top 13. U.S. firms have also facilitated Japanese investors' access to the U.S. Treasury securities market.

Foreign firms have become especially active in equities trading. American firms have 10 of the 25 foreign-owned seats on the 124-seat Tokyo Stock Exchange. In 1989, the foreign share of secondary market turnover in equities approached 6 percent, contrasting sharply with the small shares that major foreign firms are allocated in domestic equity underwriting syndicates. U.S. firms have also been especially active in derivative markets, particularly those for bond and stock index futures. Eight U.S. securities branches and four U.S. bank branches have also joined the Tokyo International Financial Futures Exchange.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In the 1970s, U.S. and other foreign securities firms were fringe players in Japanese securities markets. By 1980, only four foreign firms (all U.S.) had established Tokyo branches. In the 1980s, the U.S. presence increased notably as Japanese financial markets were liberalized and opened, partially as a result of the Ministry of Finance-U.S. Treasury Yen/Dollar Talks. This dialogue was formally launched by the joint "Report on Yen/Dollar Exchange Rate Issues," published in May 1984. In April 1988, the discussions evolved into the U.S.-Japan Working Group on Financial Markets.

By the late 1980s, foreign securities firms were generally confident about the right to establish in Japan and, in principle, to enter all lines of business open to domestic counterparts, although full and easy access to the Japanese investor base and entire range of securities activities has remained difficult.

Entry and Establishment

The establishment of foreign securities companies in Japan is governed by two securities laws: the Foreign Securities Firms Law (FSFL) and the Securities Exchange Law (SEL). The FSFL was designed to administer entry and regulation of foreign securities firms, and refers primarily to the establishment of a branch, which requires a MOF license. A firm wishing to establish as a subsidiary must apply under the provisions of the SEL. All foreign securities firms in

Tokyo are currently branches, primarily of offshore subsidiaries of the parent firm. The establishment of a representative office requires only prior notice to MOF. Although a reciprocity provision exists in Japanese banking law with respect to establishment, there is no legal or regulatory reciprocity provision for foreign securities firms in Japan.

Application for establishment of an additional branch office of a foreign firm resident in Japan is treated as a de novo branch application. Each additional branch must be separately capitalized, in contrast to the treatment of a resident subsidiary's branches or those of a domestic securities firm. By mid-year 1990, only four foreign firms had established more than one branch.

Prior to 1986, MOF had indicated a preference for foreign firms to enter Japan as branches established under the FSFL. In 1986, however, MOF announced that it would consider applications by foreign securities firms to establish subsidiaries (under the SEL). Foreign firms, however, have continued to enter as or remain branches, possibly due to tax and operating considerations. Acquisitions, takeovers, mergers or joint ventures involving a Japanese securities firm with either a domestic or foreign securities firm are regulated primarily by Japanese anti-monopoly law. In general, a financial firm may not hold more than 5 percent of the equity, whether voting or nonvoting, of another firm, unless specifically approved by the Japan Fair Trade Commission (FTC). Although some foreign firms have reportedly considered entry into the Japanese market via this approach, there have been no mergers or acquisitions.

As noted earlier, banks are generally prohibited under the SEL (Article 65) from entering the securities business, although over the past five years MOF has interpreted the FSFL to permit licensing of nearly 30 U.S. and European banks to open securities branches in Japan through overseas joint venture affiliates (in which the parent financial institutions own no more than 50 percent). The MOF has not permitted overseas affiliates of Japanese banks to enter the domestic securities market.

Operations and Market Access

Although the Japanese Government espouses a policy of national treatment and American firms have few remaining complaints about blatant regulatory discrimination, market access problems persist. The regulatory regime continues to suffer from lack of transparency. A combination of Japanese laws, regulations and market practices frequently bar foreign firms from offering products and services at which they excel worldwide. Moreover, a staggered approach to opening new markets as they evolve has made effective market access difficult, and attendant operating costs greater.

Investment Trusts Management Companies: For example, foreign firms have been excluded from the $400 billion investment trust (mutual funds) market, due to MOF's licensing policy. The mutual fund market in Japan is monopolized by 15 licensed investment trust management companies, all of which are affiliated with one of the major Japanese securities firms. December 1989 changes in the official licensing policy will potentially permit additional domestic and, for the first time, foreign firms. Although some changes treat foreign firms better than potential new domestic entrants, the rigorous standards implied by new criteria, which are based on the profile of existing firms in the industry, effectively form a substantial barrier to entry. As a result, new entry will probably be minimal. Only four foreign firms applied for licenses by the February 1990 deadline for the first round of annual licensing (one U.S. firm, two U.K. firms and one U.S./U.K. firm). No Japanese firms applied. (In October 1990, MOF granted preliminary investment trust management to the two U.K. firms. The other two foreign firms are still awaiting licenses.) Even if all four firms are granted licenses, the number of participants in the market will remain minuscule compared to other industrial countries where the number of participants can approach the thousands.

Pension Funds: Pension fund management is another example of step-by-step liberalization that impedes foreign entry. Legislation effective April 1, 1990, authorized a new group of firms, licensed discretionary investment advisors, to manage corporate pension funds. While this move could potentially increase foreign firms' access to the management of pension funds, existing and new regulations will limit foreign firms' ability to exploit areas of competitive advantage and may place them at a disadvantage with respect to Japanese firms. Implementing regulations specify the distribution of the assets of a fund (including restrictions on investment in equities, real estate and foreign currency-denominated assets, and a requirement that at least 50 percent of assets for all practical purposes be invested domestically). Portfolio specialization is restricted by requiring that individual managers follow a specified asset distribution scheme. Further regulations will effectively limit the number of new contracts available to investment advisors: management is limited to new money accumulated after a pension fund obtains a license, and regulations establish a minimum contract floor of one billion yen ($6.6 million). These restrictions and the failure to require fund managers to publish their performance record will minimize the role foreign firms can play in offering asset management skills which are performance driven and renowned in other markets.

Access by Japanese Investors to Foreign Financial Markets: The Foreign Exchange Law and the Foreign Securities Company Law limit the ability of Japanese investors, both individual and institutional, to access overseas markets and products directly. The effect of such regulations has been to force the bulk of Japanese portfolio investment overseas through Ministry of Finance "licensed securities firms" and "authorized foreign exchange banks in Japan." Not only do these restrictions funnel Japanese investor activity primarily through Japanese institutions, but they have provided a regulatory means by which MOF can moderate and direct this activity. MOF's July 1990 actions, announced at the May 1990 meeting of the U.S.-Japan Working Group on Financial Markets, to broaden direct access to overseas markets by raising the ceilings on overseas accounts for individuals, permitting corporations to have such accounts, and allowing these accounts to be used for portfolio investment, should redress some of these concerns. Also in response to May commitments, the Finance Ministry introduced changes to the Foreign Securities Companies Law, which became effective November 26, to permit foreign securities firms not licensed in Japan to offer securities on a "non-solicitation" basis to individual and corporate investors resident in Japan. Although all of these changes are positive, they leave intact the basic regulatory structure.

Introduction of Financial Products: As reported in earlier national treatment studies, and regularly in discussions between Treasury and the MOF over the past six years, a combination of statutory, regulatory and informal guidance measures frustrates and sometimes prevents the introduction of new products and services. The highly segmented nature of business lines and the regulatory structure can compound these problems. The relatively narrow definition of a "security" under the Securities and Exchange Law in particular has contributed to the difficulties and lengthy delays some securities firms have encountered, as has the reporting and/or approval framework of the Foreign Exchange Law, when the product or service has a non-yen component. Foreign firms have questioned the need for multiple personal visits to various MOF bureaus and the extensive informal guidance which must be carefully interpreted. In May 1990, MOF announced that would expedite the approval process and approve several pending applications which could help rectify this problem. Subsequently, in mid-June, MOF formally approved several new products for foreign securities firms, which incorporated foreign exchange transactions such as currency options. In addition, in June, MOF gave the green light to dollar denominated money market funds. In September, MOF approved a foreign securities firm's application to offer credit card asset-backed securities in Japan. At the May meeting, MOF also announced its intention to approve the introduction of the Chicago-based GLOBEX electronic futures and options trading system.

Foreign Exchange Business: For years, foreign securities firms have been frustrated by Japanese laws (primarily the Foreign Exchange Law) which prohibit them from offering the full range of foreign exchange services in Japan that they can offer elsewhere. They have argued that such restrictions are anachronistic and illogical: Japan is the only major international market where firms encounter such restrictions. Even though such restrictions apply to domestic and foreign firms, they disproportionately affect foreign securities firms by denying them the opportunity to provide products and services at which they excel worldwide. These restrictions may be partially alleviated by MOF's announcement at the May 1990 Working Group Meeting that MOF intends to permit offshore, 50 percent-owned qualified bank subsidiaries of foreign securities firms to establish branches in Tokyo. These banking branches will be able to engage in a wide range of foreign exchange business -- an approach MOF is not yet ready to offer domestic Japanese securities firms. Even with such an affiliate bank, however, some firms question whether existing foreign exchange restrictions could still bar foreign securities firms themselves from conducting a full range of competitive securities-related activities, such as the execution of swaps. Moreover, the measure, while welcomed, is viewed as second best to the removal of restrictions preventing securities firms from offering foreign exchange services outright.

Domestic Underwriting: Despite persistent efforts and growing domestic client bases, foreign firms can rarely secure more than a minimal share in underwriting syndicates. They allege that this is anomalous when viewed against their share of secondary market trading in Japan, their leading positions in overseas underwritings, and the significant positions accorded Japanese firms in such underwritings. Although the issue is not a regulatory matter, it reflects the market power of the major Japanese firms who lead manage the offerings and is reinforced by the "1000-share rule" for initial public offerings (IPOs) which is enforced by the stock exchanges and the Securities Dealers Association. This rule impedes a foreign firm's ability to place substantial IPO equity shares with its (mainly institutional) clients by limiting each client's maximum to 1000 shares. Foreign firms' participation is also curbed by the securities industry's "30 percent rule," a "voluntary" measure limiting the proportion of each underwriter's shares in a public offering which may be placed with: (a) financial institutions (banks and insurance companies); and (b) listed nonfinancial companies.

Transparency: Inadequate transparency of policies and regulations, and their formulation, has been one of the most frequently mentioned hurdles encountered by foreign firms even though it is one where MOF has made procedural improvements over the past few years. Notable successes include the consultation process followed in formulating new capital adequacy standards for securities companies, and in creating a fair and transparent pricing regime for Eurodollar warrants in Japan. In both instances, U.S. firms were consulted and able to contribute to substantive results. In addition, foreign firms have appeared more frequently as witnesses to MOF advisory councils. In a few cases, foreigners have been given membership in informal MOF and securities industry working groups. However, despite such efforts, many foreigners allege that meetings of MOF-sponsored councils, such as the Securities Exchange Council, are not truly open to foreign members and that materials handed out at the meetings are circulated among larger domestic institutions on a reciprocal basis. Thus, while information appears to flow freely among domestic firms and regulators, foreign firms have had difficulty in breaking into the dialogue.

Miscellaneous Issues: U.S. securities firms have raised three other issues. First, securities firms in Japan may carry margin accounts for nonresident investors only for hedging purposes. This has impacted foreign firms disproportionately since they have a large number of non-Japanese customers. Second, January 1990 revisions to regulations regarding domestic yen commercial paper permit securities firms to issue CP up to certain limits for the first time. Issuers, however, must be listed companies or have made three continuous years of stringent disclosure (which cannot be done retroactively). Foreign securities firms, whose headquarters are typically offshore subsidiaries of their U.S. parent and are not listed, have had no reason in the past three years to make rigorous annual disclosures. Thus, this requirement will effectively prevent foreign securities firms from obtaining access to this new and important avenue of fund raising for the next several years.

Third, MOF's revision of capital adequacy guidelines left intact the 10:1 gearing ratio on liabilities-to-capital, despite the application of a thorough risk-weighting scheme to assets. This approach is more onerous than the comparable U.S. and U.K. systems. It also disproportionately impacts foreign firms whose Japanese operations generally are less capitalized than their Japanese competitors based in Japan. Early abolition of the 10:1 gearing ratio appears warranted.

Despite the foregoing, problems continue to be addressed. For instance, many issues noted in the 1986 National Treatment Study Update have been acted upon. These include: adequate TSE memberships (although firms would like to be able to purchase or sell existing seats); greater foreign access to the government bond underwriting syndicate (although many firms would like to see 100 percent auctions of 10-year JGBs and a different way to issue five-year discount bonds which are still issued by syndicate frequently at losses to member firms); full accreditation of foreign bond rating companies; some improvements in transparency, including foreign firm members on the board of the Japan Securities Dealers

Association; introduction of foreign financial futures in Japan; short-selling of government securities; and MOF's stated intention to expand the ability of foreign securities firms to engage in foreign exchange activities.

Nevertheless, critics maintain that a more fundamental and comprehensive approach to deregulation and market liberalization is necessary, both to enhance the attractiveness of Japanese markets and to create the perception that truly competitive opportunities exist in Japan. Thus, while acknowledging recent progress, many foreign firms today would still endorse the sentiment expressed in the conclusion from the 1986 Update:

> "Apart from (formal) national treatment issues, there is a general feeling by foreign firms that the overall pattern of market practices and non-prudential regulations in Japan places them at a competitive disadvantage vis-a-vis Japanese firms in both the domestic and international marketplace. Outside Japan, foreign firms see themselves as very competitive in an increasingly internationalized securities market, in which their major competitors are frequently the foreign affiliates of Japanese firms. American firms, in particular, feel that their competitive advantage lies in their ability to offer new innovative financial products and a wide range of financial services. Some are frustrated, however, because they feel unable to exploit this strength in Japan due to their inability to offer many of these products and services there. On the other hand, Japanese firms are seen as having the ability to experiment, innovate and imitate in open and competitive markets outside Japan. These U.S. firms feel that by the time new products and techniques are permitted in Japan, Japanese firms have caught up with their foreign counterparts and the foreign firm no longer has any advantage over a Japanese firm. Meanwhile, Japanese firms have been able to compete aggressively for market share internationally, supported financially by their dominance of the Japanese market. MOF states that it admits new products when satisfied that there are no problems from the viewpoint of investor protection and that it has no intention of seeking advantage for Japanese firms."

FINANCIAL MARKET DISCUSSIONS

The U.S. Treasury and Japanese Ministry of Finance have been engaged in financial market discussions since 1984. During preparations for the May 1984 "Report on Yen/Dollar Exchange Rate Issues" and in subsequent follow-up discussions, Treasury and MOF officials formally met 15 times. The Report and discussions initially focused on the need to: liberalize Japanese domestic capital markets, primarily by deregulating interest rates and creating an attractive money market; internationalize the yen, primarily by removing restrictions to a freely functioning Euroyen market; and improve foreign firms' access to Japanese financial markets across a range of market sectors. In April 1988, the agenda of the Yen/Dollar Working Group was broadened to include additional U.S. and international issues and the Group was renamed the "U.S.-Japan Working Group on Financial Markets." Although many of the specific commitments outlined in the 1984 Report have been met, the discussions have continued to address related follow-up issues as well as the entire spectrum of Japanese banking and securities markets and foreign firms' access to them.

CONCLUSION

Full and easy access to the Japanese investor base and entire range of securities activities is still difficult despite continued efforts to open and liberalize Japanese securities markets which have resulted in greater participation by foreign firms. Japanese authorities have undertaken important market opening measures in recent years. These include: broadening access to the government bond market (by increasing foreign firms' allocation in the underwriting syndicate in October 1988, and in April 1989 adopting a true price auction for 40 percent of 10-year issues, which was expanded to a 60 percent auction in fall 1990); increasing the number of seats on the Tokyo Stock Exchange in 1988 and 1990 (resulting in 10 seats for U.S. firms of the 25 foreign-owned seats on the 125 member exchange); introducing a variety of securities products in domestic and Euroyen markets (e.g., commercial paper) and incremental liberalization of the domestic corporate bond market (including expanding the list of eligible issuers, introducing bond ratings and initiating shelf registration); approval of some new products such as GLOBEX

(Chicago-based electronic futures trading system); establishment of futures and options markets and broadening residents' access to those markets overseas; overhaul of securities firms' capital guidelines (to eliminate practical disadvantages foreign firms had faced); and periodic efforts to improve transparency (e.g., consulting with the foreign community regarding capital guidelines and changes in the domestic equity warrant market).

Nevertheless, foreign firms argue that problems remain that prevent them from achieving a comparable degree of success achieved in other markets. For example, they cite impressive track records in investment trust management and pension fund management in other markets. Yet despite recent regulatory changes to open those markets in Japan, subsequent implementing measures and entry criteria will effectively keep foreign firms' participation minimal. In addition, foreign firms have argued that a combination of Japanese laws and practices make difficult both the introduction of new products into Japan and the ability of Japanese investors to access foreign markets and products abroad. Foreign securities firms have also maintained that foreign exchange restrictions, which apply to domestic securities firms as well, have unfairly placed them at a disadvantage, since they prohibit foreign firms from efficiently offering innovative products and services at which they excel worldwide. At the May 1990 meeting of the U.S.-Japan Working Group on Financial Markets, MOF announced a variety of measures which, when fully implemented, should relax some of the restrictions on introducing new products, accessing overseas markets and offering foreign exchange services. Foreign firms have also cited difficulties underwriting and distributing domestic bond and equity issues. Finally, they maintain that problems pertaining to transparency (including the lack of a reliable consultation process) continue to place them at a disadvantage compared to their domestic counterparts.

In general, Tokyo is viewed as a key financial center, but one in which change has not kept pace with that in other major centers. By any standard of openness, Tokyo lags substantially behind New York and London. Moreover, as new markets and opportunities arise in Japan, the ability of foreign firms to use their expertise and take advantage of those possibilities is frequently hampered by the incremental market-opening approach Japanese authorities have adopted. Thus, despite significant steps forward, the process of creating a truly level playing field is far from complete.

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* U.S. dollar figures calculated at the following rates:

1988-1989: $1 = yen 126.87 (Average Sept. 1988-March 1989)
1989: $1 = yen 137.96 AA; 143.45 YE
1990: $1 = yen 151.39 (June 1, 1990)

AA = Annual Average
YE = Year-End

17. Republic of Korea - Banking

SUMMARY

The Korean financial system has long been managed to provide the Government maximum control in directing financial resources to further policy goals, including industrial policy. The emergence of a strong, competitive domestic financial services sector has been impeded as a result.

The banking system in Korea is comprised of 10 nationwide commercial banks, which play a dominant role in the commercial banking system; 10 smaller regional banks oriented to serving local industry; seven "specialized" banks, established with capital subscribed by the Government to provide financial support for particular sectors of the economy; and branches of 52 foreign banks, including 14 U.S. banks, which have specialized in wholesale banking.

With one exception, foreign banks have been allowed to establish operations in Korea only by opening branches of the parent bank, subject to strict criteria not publicly announced by the Ministry of Finance until late 1989. Foreign banks may also open representative offices. The primary regulator of the banking system is the Bank of Korea, comprised of the Monetary Board and the Office of Bank Supervision and Examination.

Due in part to the controlled nature of the financial system and in part to differential treatment in a number of areas, foreign banks face policies and practices in Korea which impede their ability to establish operations and compete on an equal footing with local banks. Although the foreign banks played an important role as suppliers of foreign exchange during the early years of Korea's economic development, that role has diminished since Korea became a surplus country in 1986. For that reason, in part, the Government has reduced foreign banks' primary source of local currency financing -- swap facilities with the Bank of Korea -- by a nominal 10 percent annually in 1987, 1988 and 1989. Coupled with appreciation of the won over the same period, U.S. banks estimate that the actual cumulative effect of the reductions has been 47 percent of the local currency funds previously available through swap transactions.

The Korean Government has recognized in principle that the reduction in swaps must be replaced with acceptable alternative sources of local currency funding. However, funding sources of key interest to foreign banks, such as the issuance of certificates of deposit and full participation in the call and trust markets, have not yet been allowed to develop effectively. Moreover, discrimination exists in both funding sources. As their local currency lending capabilities have been reduced, foreign banks' ability to serve their existing home office customers and develop a local customer base has eroded. According to the Bank of Korea, foreign banks' market share in Korea declined between 1986 and 1989. Foreign banks' share of loans of deposit money banks dropped from 10.2 percent in 1987 to 6.8 percent in 1989. Over the same period, foreign banks' share of deposits dropped from 1.5 percent to 1 percent. Foreign banks' share of total assets fell from 7.7 percent in 1987 to 5.7 percent in 1989.

U.S. financial services firms point out that given their potential competitive advantage in innovation and technology, the restrictive nature of the financial system is itself a significant constraint on their ability to compete effectively. Further liberalization of the system, as well as the elimination of specific barriers, is necessary if foreign banks are to receive equality of competitive opportunity. The Korean Government has taken some gradual steps toward financial and capital market deregulation since 1986. In some instances, however, liberalization has been less real than it may appear, as evidenced by the Government's continued efforts to influence through window guidance interest rates ostensibly deregulated in December 1988.

The Treasury Department held Financial Policy Talks with the Korean Ministry of Finance in February and again in November 1990 with the express purpose of pressing for financial sector liberalization, including greater regulatory transparency, and national treatment for U.S. financial institutions. During the talks, Korean government officials reiterated their ultimate goal to liberalize and provide national treatment and in 1990 they increased the CD issuance and paid-in capital ceilings for foreign banks. However, progress in resolving problems has been very slow and no timetable for dealing with them has been produced. The basic issues remain with no indication when foreign financial service providers will be accorded equality of competitive opportunity in the Korean market. The Department of the Treasury will continue to encourage the Korean Government to improve the operating environment for foreign banks and to liberalize the financial sector. Liberalization would provide not only a more equitable climate for foreign banks, but significant benefits for the Korean economy as well.

Thus, despite discussions between the U.S. Treasury and the Korean Ministry of Finance, during which the Koreans appeared to accept the need for liberalization in their banking market, significant denials of national treatment continue although improvements are promised for 1991.

As of year-end 1989, 14 U.S. banks operated 20 branches with assets of $4.4 billion in Korea. Two U.S. banks also reported a noncontrolling interest in a Korean bank with assets of $2.5 billion and a leasing company with assets of $647 million. This presence represents an increase of approximately $2.7 billion in assets since year-end 1985. At that time, 16 U.S. banks had 19 branches in Korea with assets of $3.4 billion. U.S. banking corporations reported a controlling interest in three nonbank subsidiaries or affiliates in Korea with total assets of approximately $1.4 billion. Two additional U.S. banks maintained representative offices only.

At the end of 1989, seven Korean banks operated seven agencies with assets of $1.7 billion, 13 branches with assets of $3.3 billion, and four subsidiaries with assets of $641 million in the United States. Korean banks maintain 13 representative offices in the United States. This presence represents an increase of four branches and of $2.7 billion in assets since year-end 1985. At that time, six Korean banks operated a total of nine branches and seven agencies (plus three representative offices) in the United States with total assets of $2.5 billion. An additional six Korean banks maintained only representative offices in the United States. Also as of year-end 1985, Korean banks reported majority ownership in four U.S. chartered banks with a total of 11 branches and aggregate U.S. assets of $396 million.

OVERVIEW

Domestic Banking Market

According to the Ministry of Finance (MOF), its policy since the early 1980s has been to liberalize and deregulate the financial markets through privatization of commercial banks and alleviation of governmental intervention. MOF maintains, however, that Korea's financial system differs from that of the U.S. due to the perception in Korea that the banking sector should center on creditworthiness of banks rather than "profit-oriented banking operations through excessive competition."

Since 1986, the Government has taken gradual steps toward financial and capital market deregulation, by announcing a revised Mid-Term Plan for Liberalization of the Capital Market in 1989-1992 and implementing a system to determine exchange rates on the basis of interbank transactions of the previous day. However, the Government still plays a significant role in managing Korea's financial sector through the use of extensive controls on capital inflows and outflows, holdings of foreign exchange, interest rates, the introduction of new financial products, credit allocation (enforced lending ratios), and local and foreign currency lending. Although in December 1988, the Government deregulated lending rates and rates for term deposits with maturities of two years or more, it continues to influence these rates through extensive window guidance to banks.

The Bank of Korea (BOK) also uses window guidance to steer other short-term banking decisions in support of policy goals. Regulators often rely on informal interpretation of regulations which are in some respects unclear and out of step with developments in the market. Guidance is at times inconsistent and in some cases, such as the control of interest rates, contradictory to existing regulations. Sanctions sometimes appear to be used selectively.

In mid-1990, differences arising from the lack of transparency in the regulatory environment came to a head when banking regulators cracked down on what they alleged to be repeated violations of Korean banking regulations by foreign banks. The ROKG announced that effective June 4, 1990, it would apply stiff "personal sanctions," including firing, demotion and cuts in pay, against foreign bank branch managers and their Korean staff who violate BOK regulations, a system which was already in place for domestic banks. The foreign banks maintained that the problems arose from ambiguities in the regulations and inconsistency in interpretation and enforcement. In an effort to achieve greater transparency, the foreign banks asked that bank regulators join them in a working committee to clarify the issues. Through the committee, the foreign banks have submitted recommendations on improving the regulatory environment which the Government now has under review.

The banking system in Korea is comprised of 10 nationwide commercial banks, 10 regional banks (one in each of Korea's 10 provinces), branches of 52 foreign banks and seven "specialized" banks. Until 1983, the five major nationwide banks were majority-owned by the Government but now are in private hands. The primary regulator of the banking system is the Bank of Korea, comprised of the Monetary Board, charged with overall responsibility for formulating and administering monetary and credit policies, and the Office of Bank Supervision and Examination (OBSE), which supervises banking operations.

The 10 nationwide commercial banks, three of which were established in 1989, continue to play a significant role in Korea's commercial banking system, although the specialized banks and nonbank financial institutions have become increasingly important competitors since 1986. Total assets of the nationwide commercial banks amounted to about 55 trillion won ($80.9 billion).[*] The nationwide commercial banks held 44 percent of the banking system's deposits, which accounted for 53 percent of their funds, while borrowings from the BOK accounted for an additional 10 percent of their sources of funds in 1989.

The seven specialized banks, directed and supervised by the Government, were originally created in the 1960s to provide funds to particular sectors where credit was insufficient. However, they have recently expanded into commercial banking as well. Competing with commercial banks, they now rely heavily on deposits for sources of funds in addition to the issuance of debentures and borrowing from the Government. Deposits provided 59 percent of their sources of funds in 1989. The specialized banks' assets amounted to 50 trillion won ($74.5 billion) and they held 40 percent of the total assets of deposit money banks in 1989.

The 10 smaller regional banks are oriented toward serving the small and medium-sized enterprises in their provinces. Each has two branches in Seoul and additional branches in their respective provinces. Total assets of the regional banks amounted to 13 trillion won ($19.4 billion) or 10.6 percent of the total assets of commercial banks in 1989.

Major Accounts of Deposit Money Banks, As of End-1989
(Won Billions) (1)

	Total	Nationwide Commercial Banks	Specialized Banks	Regional Banks	Foreign Banks Total	U.S. Banks
Sources of Funds						
-Deposits	67,106	29,163	29,071	8,380	492	238
	(100)	(43.5)	(43.3)	(12.5)	(0.7)	(0.4)
-Borrowings from BOK	9,646	5,642	3,337	655	12	0
	(100)	(58.5)	(34.6)	(6.8)	(0.1)	(0)
-Paid-In Capital	6,108	3,960	787	1,042	319	83
	(100)	(64.8)	(12.9)	(17.1)	(5.2)	(1.4)
Inter-Office	3,642	16	91	0	3,535	1,419
	(100)	(0.4)	(2.4)		(97.0)	(39.0)
-Other	38,221	16,016	16,362	3,111	2,732	1,287
	(100)	(41.9)	(42.8)	(8.1)	(7.1)	(3.4)
Total Assets/ Liabilities	124,723	54,797	49,648	13,188	7,090	3,027
	(100)	(43.9)	(39.8)	(10.6)	(5.7)	(2.4)
Uses of Funds						
-Loans In Won Currency	62,547	26,210	27,492	6,003	2,842	1,353
	(100)	(41.9)	(44.0)	(9.6)	(4.5)	(2.2)
-Foreign Assets	5,400	3,144	1,419	212	625	274
	(100)	(58.2)	(26.3)	(3.9)	(11.6)	(5.1)
-Securities	10,583	4,115	3,880	2,336	252	181
	(100)	(38.9)	(36.7)	(22.1)	(2.4)	(1.7)
-Loans In Foreign Currency	6,479	1,970	2,604	74	1,831	274
	(100)	(30.4)	(40.2)	(11.4)	(28.3)	(4.2)
-Other	39,714	19,358	14,253	4,563	1,540	945
	(100)	(48.7)	(35.9)	(11.5)	(3.9)	(2.4)

1/ Figures in parenthesis indicate the percentage share of each category of account held by each group of banks.

Source: The Bank of Korea

Nonbank financial institutions (NBFIs), introduced in the 1970s to attract so-called "curb market" funds into the organized financial sector, are also growing in importance as competitors for the commercial banks. NBFIs may apply higher interest rates on their loans and deposits and enjoy greater freedom in the management of assets and liabilities than banks. As a result, NBFIs have significantly increased their market share through the 1980s. NBFIs share of total deposits rose from 30 percent in 1980 to 58 percent in 1989, and of total loans, from 35 percent to 48 percent. According to the BOK, NBFIs in Korea include three development banks (the Korea Development Bank, the Export-Import Bank of Korea and the Long Term Credit Bank), 32 investment and finance companies and six merchant banks, 19 life insurance companies, and about 4500 savings institutions.

U.S. Presence in the Market

Fifty-two foreign banks from 13 different countries have branches in Korea, with a total of 67 branches in Seoul and Pusan. Total assets of foreign banks amounted to 7 trillion won ($10.4 billion) in 1989, or 5.7 percent of total assets held by deposit money banks. There are also 22 representative offices of foreign banks in Korea. Historically, foreign banks have done well in Korea, registering annual profit growth rates of over 25 percent in 1987 and 1988. In 1989, however, growth in profits fell to 5 percent. According to the BOK, foreign banks' return on equity (ROE) dropped from 34 percent in 1985 to 18.67 percent in 1989; U.S. banks' ROE dropped from 37.15 percent in 1985 to 21.32 percent in 1989. The most profitable foreign bank in Korea in 1989 was a U.S. bank with an ROE of 19.45 percent; the bank expects to make barely half of this ROE in 1990.

The 14 U.S. banks in Korea have a total of 20 branches located in Seoul and Pusan. At the end of 1989, U.S. bank branches operating in Korea held a total of 3 trillion won ($4.4 billion) in assets, or 2.4 percent of total assets of deposit money banks.

Four U.S. banks have representative offices in Korea. Two U.S. banks reported noncontrolling interests in the Koram Bank, a joint venture with thirteen Korean companies, with assets of 1.7 trillion won ($2.5 billion) in 1989. Three U.S. banks each have a non controlling interest in a nonbank subsidiary or affiliate, which include a leasing company, two merchant banks and a credit card company.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The MOF strictly regulates the establishment of new financial institutions for "the protection of depositors and because of the perception that banking should emphasize creditworthiness rather than the maximization of profits."

Under Article 27 of the Banking Act, all banking institutions are prohibited from purchasing or retaining ownership of shares in any other banking institution, or shares in excess of 10 percent of the shares issued by any other business firm, except when given approval to do so by the banking regulators. Although the Banking Act in principle permits foreign banks to establish banking subsidiaries with the approval of the monetary board, MOF has not allowed foreign banks to do so. Foreign banks have been permitted to establish operations in Korea by opening a branch of the parent bank, with the approval of the Ministry of Finance and the Bank of Korea, or by opening a representative office, with the approval of the Bank of Korea.

According to criteria announced by the Ministry of Finance in 1989, to be eligible to open an initial branch in Korea, a foreign bank must be in the ranks of the top 500 banks in the world on an asset basis. Before a representative office will be given branch status, it must have been in operation for at least one year. To be eligible to open an additional branch in a different region, the total assets of the main branch office must exceed 100 billion won ($140 million); the main branch office must have been in operation for at least five years; and the new regional office "must contribute substantially to the development of the regional banking system." To qualify to open an additional branch in the same region, the foreign bank must be among the top 100 banks in the world on an asset basis; the assets of the main branch office must exceed 300 billion won ($420.1 million); the main branch office must have been in operation for at least ten years and the existing regional office for at least five years; and the foreign bank must not have been cited for violating Korean banking laws and regulations within one year of application.

In practice, it has been exceptionally difficult for foreign banks to open additional branches in Korea. The only U.S. bank which has applied extensively to open additional branches has succeeded in opening only three over the past three years.

The criteria for branching announced in 1989 add greater transparency to the branch licensing process. However, they also exclude all but four of the 52 foreign banks operating in Korea and all but two of the 14 U.S. banks operating in Korea from qualifying to establish additional branches.

The MOF argues that since Korean financial institutions operate to ensure "public credibility" rather than to "stress the maximization of efficiency through excessive competition as is seen in the U.S.," barriers to entry into and exit from the banking market are provided for domestic and foreign financial institutions alike. MOF also argues that different criteria for domestic and foreign banks are inevitable for prudential and cultural reasons. However, the requirement that the main branch be in operation for 10 years, and a regional branch for five, before additional branches may be opened, appears arbitrary and excessive for normal prudential considerations and clearly discriminatory.

By contrast, one of the three new Korean nationwide city banks that opened in 1989 was authorized to establish 12 branches immediately, an additional eight branches by the end of 1989 and up to 40 branches by the end of 1990. The other two new domestic nationwide banks opened in 1989 were also allowed multiple branches soon after their establishment. It does not appear that these additional branches will have to be independently capitalized, as is the case for foreign banks (discussed below).

The Government has recently advised that foreign banks in Korea may establish as many separate offices as they wish without additional licenses on the condition that those offices are not engaged in client contact and that there are no signs indicating a banking business. However, any other physical presence outside the main branch premises, including automated teller machines (ATMs), is considered an "additional branch." Therefore, foreign banks which wish to establish ATMs, offices to handle remote processing operations where customer contact or nameplate is required, or marketing/loan production operations on premises other than those of the main branch must apply for a branch license for these offices. Moreover, as "additional branches," such offices must also be separately capitalized. The requirement that any physical presence outside the main branch be licensed and capitalized as an additional branch imposes additional financial and administrative burdens on foreign banks.

Operations: Inadequate access to reliable sources of local currency funding is the chief impediment to U.S. banks' ability to compete effectively in Korea. In its early years of economic development, Korea needed foreign exchange to build its export-led economy and support its companies in their overseas activities. Until Korea began to register current account surpluses in 1986, foreign banks were a key source of foreign exchange for the Korean economy. To encourage foreign banks to enter the Korean market, the Government provided them relatively favorable treatment vis-a-vis the domestic banks in some respects. As a rule, foreign banks have been fully or partially exempted from informal requirements levied on domestic banks for purposes of credit allocation, liquidity control and to support other economic and social policy objectives. Foreign banks are not required to purchase monetary stabilization bonds (a key tool for liquidity control) in the primary market and are required to lend only 25 percent of their total loan portfolio to small and medium-sized industry (domestic banks are required to lend 35 percent). Most importantly, the Government has provided foreign banks exchange risk-free dollar/won swaps from the BOK to finance local currency funding. Virtually all have tended to specialize in wholesale banking.

With Korea's shift into current account surplus in 1986, its need to swap local currency with foreign banks to obtain foreign exchange has diminished. As part of its current policy to eliminate preferential treatment for foreign banks, the Korean Government began to reduce foreign bank swap limits in 1987, cutting them by 10 percent annually in 1987, 1988 and 1989. Since swap limits are denominated in dollars, the effective reductions in the swap lines are higher when won appreciation is taken into account. U.S. banks estimate that their access to local currency funding has been cut by 43 percent since 1987 as a result of reductions in swaps and appreciation of the won, which has reduced the value of the swap lines in terms of won. With the reduction in their local currency lending capabilities, foreign banks' ability to develop and serve their customer base has eroded. The BOK reported in August 1990, that following the reductions in swaps, foreign banks have shown reduced growth and declining market share: their share of deposit money bank loans dropped from 10.2 percent in 1987 to 6.8 percent in 1989, and of deposits, from 1.5 percent to 1.0 percent. Foreign banks' share of total assets dropped from 7.7 percent in 1987 to 5.7 percent in 1989.

In 1989, the Republic of Korea Government (ROKG) indicated to the foreign banks in an informal "white paper" that it recognizes, in principle, that swap reductions must be accompanied by increased access to other sources of won funding. The Government has taken steps to develop the issuance of negotiable certificates of deposit (CDs), the trust business and the call market as possible alternatives. The MOF maintains that the increased access to local currency funding deriving from these sources plus increases in paid-in capital allowed to foreign banks, totalling 829.7 billion won ($1.16 billion) between December 1986 and June 1990, "more than offsets" the reduction in swaps, amounting to 684.2 billion won ($.95 billion). By MOF's calculations, the 52 foreign banks operating in Korea enjoyed a net increase in access to local currency funding of 145.5 billion won ($200 million) between the end of 1986 and mid-1990 and that the net increase grew further by the end of September. However, differential treatment of foreign banks in these areas, as well as certain structural limitations, limits their utility as alternative funding sources. In practice, the reductions in foreign banks' swap facilities have not been replaced with adequate alternative sources of local currency funding.

In addition, as foreign banks move away from their primary focus on foreign currency lending and attempt to develop other sources of revenue, restrictions they face in pursuing new lines of business have loomed larger.

Foreign banks were authorized to issue negotiable certificates of deposit in September 1986. However, since CDs are one of the few short-term instruments for which deposit rates have been decontrolled, the ROKG has established ceilings on CD issuance by banks to prevent a shift of funds out of other instruments with interest rates which remain controlled. These ceilings and the limited maturity structure of CDs offered to nonbank depositors (from 90 to 180 days), prevent CDs from functioning as a flexible and liquid funding instrument.

In addition, foreign bank branches and domestic banks are subject to different ceilings on CD issuance. Until June 1, 1990, the individual foreign bank branch limits were equal to 120 percent of the sum of paid-in capital (including capital surplus) and the portion of retained earnings in Korea set aside as legal reserves. In response to talks with the U.S. Treasury, the BOK on June 1, 1990, raised foreign banks' CD issuance ceilings to 150 percent of paid-in capital and reserves, or 10 billion won ($14 million), whichever is greater. Foreign banks are now making fuller use of CD funding. According to MOF, foreign banks' share of CDs issued in Korea has risen from 2.6 percent at the end of 1988 to 13.3 percent in September 1990.

The 10 nationwide commercial banks are subject to a CD ceiling equal to 40 percent of capital (including capital surplus) plus legal reserves. However, in the case of the domestic banks, the "capital" employed is global capital, which according to OBSE ranges from 100 billion to 600 billion won ($70 million to $840.2 million). For foreign banks the capital employed in the ceiling formula is local branch capital -- averaging 7 billion won ($9.8 million) for U.S. banks. Thus, although the formula for calculating limits on CD issuance by foreign banks appears more generous than that for domestic banks, it is in practice substantially more restrictive.

The MOF argues that foreign banks have enjoyed a sharp increase in CD deposits since "they can offer higher interest rates for CDs than domestic banks, whose interest rates are controlled through the window guidance of the BOK." U.S. and other foreign banks have, however, also been subject to informal pressure on CD rates. MOF has indicated that despite the deregulation of CD rates, "some guidance" is required in order to maintain a normal interest rate structure. Foreign banks, which generally have offered rates on CDs that are closer to market than domestic banks, have experienced attempts at guidance. They have resisted these efforts in varying degrees on the grounds that the rates were deregulated in 1988.

The "trust" business in Korea (which differs from funds management as practiced in the U.S.) is another potentially promising source of won funding. Trust funds are not subject to Bank of Korea reserve requirements. Regulations governing management of trust accounts are less restrictive than in the more controlled loan and deposit sector, and yields on trust accounts with maturities of more than two years have been deregulated since December 1988. Foreign banks were given approval to compete in portions of the trust business in 1985. However, each branch of a foreign bank must obtain a separate trust license while a domestic bank need obtain only a single trust license for all its branches to enter into the trust business.

Until recently the process of obtaining a trust license from MOF lacked transparency. The MOF and the BOK discouraged several U.S. banks from applying for licenses on the grounds that local banks need time to establish themselves in the business before foreign banks are allowed wider participation. The MOF has clarified that to qualify for a trust license, a foreign bank branch must have been in operation for at least three years before an application for a trust license will be considered. In addition, the foreign bank's head office must hold total assets exceeding $10 billion and also be engaged in the trust business. Only 24 of the 67 foreign bank branches and only 10 of the 20 U.S. bank branches in Korea hold trust licenses, enabling them to take advantage of this new source of local currency funding.

Foreign banks which have applied for trust licenses have found that their applications become stalled in the approval process. According to the MOF, any discrepancy in time schedules for the issuance of trust licenses for foreign and domestic banks is "due to the difference in time required to review each bank's qualifications to engage in the trust business" and because "it is much more difficult... to gather data on the operations of these banks in their home countries." The MOF also contends that no U.S. bank has had its application for a trust license rejected thus far. However, several U.S. banks have been advised by the MOF not to apply for a license, since a formal application would be rejected. The MOF "denies that it engages in such advising."

According to the MOF, foreign banks "are expected to be allowed to engage in a full range of trust business beginning next year." At present, however, foreign banks which hold trust licenses are permitted to offer only "unspecified money trusts," which work essentially like deposits and require distribution through a branch network, which foreign banks lack. Unspecified money trusts currently comprise about 82 percent of Korea's trust market, according to the MOF. Foreign banks' applications to offer more lucrative, and less developed types of trust products, such as the "specified money trust" (discretionary funds management), have been denied, reportedly due to objections raised by domestic banks. Local banks, by contrast, enjoy unrestricted access to the trust market with the exception of the government-owned banks, which are also prohibited from offering specified money trusts. By contrast, a new domestic bank which opened in 1989 was given permission to enter into the full range of trust business immediately.

According to the MOF, although trust interest rates with maturities of more than two years have been liberalized, all trust interest rates relating to domestic banks continue to be regulated. As in the case of CD rates, the MOF maintains that foreign banks are "immune" from such guidance. However, since early 1990, both foreign and domestic banks have been required by the written guidelines for the management of the trust business to use a certain portion of deposits taken in trust to underwrite monetary stabilization bonds, the Government's primary tool of liquidity control, at primary issue. This further limits the effectiveness of trusts in compensating for losses in swaps.

In October 1989, the ROKG integrated the local currency call market to increase its efficiency. The market had previously been segregated into two separate trading sessions, one for domestic banks and one for foreign banks and nonbank financial institutions. Although the integrated market initially appeared to be developing effectively as an alternative source of won funding, U.S. and other foreign banks have recently encountered difficulty in obtaining funds from domestic banks, and obtaining them at competitive rates of interest when they are made available. Whereas local banks are consistently quoted rates of 11-12 percent, foreign banks are consistently quoted rates ranging from 14-24 percent for the same amounts over the same time period. Domestic banks reportedly continue to meet informally to trade among themselves.

The MOF maintains that although there remain some "unfavorable circumstances" for foreign banks in obtaining funds from domestic banks in the call market, primarily due to the "long tradition" of the market, conditions will improve in the near future as the Government "continues to urge domestic banks to rectify the situation through administrative guidelines and regulatory measures." The MOF also points out that in Korea, the call market is not considered a money market, but rather a vehicle for replenishing shortages in domestic banks' required reserves, with a shortage in one bank covered by the surplus of another.

The ROKG's use of local branch capital as the benchmark for determining a variety of funding and lending limits imposed on foreign banks is one of the most important aspects of the local regulatory framework which impedes their ability to compete in Korea. Although domestic banks are also subject to limits based on size of capital, the "capital" employed in their case is the entire bank's capital.

The problem is broadened from a regulatory impediment to competitiveness to a denial of national treatment in that the ROKG also maintains ceilings on foreign branch capital. These ceilings on local branches of U.S. banks, which are determined by the Monetary Board through a nontransparent process, have averaged around 7 billion won ($9.8 million) with an implicit upper limit of 12 billion won ($16.8 million) per branch. Domestic banks' capital, by contrast, is not subject to an explicit upper limit. In 1988 and 1989, domestic banks were permitted to increase their capital by 70-73 percent. In 1989, the MOF indicated its intention to eventually employ aggregate, or entire bank capital for foreign banks, as is the case for domestic banks, but has set no time-frame.

Foreign banks are also not permitted to participate in Korea's automated teller machine (ATM) and electronic clearing house networks. Korea's cash dispenser network, consisting of up to 1000 outlets, was established four years ago by a group of the major local banks. The network is administered by the Korean Financial Telecommunications and Clearing Institute (KFTCI), which is composed of 17 member banks, all domestic. Historically, KFTCI has been chaired by a former Assistant Governor of the BOK. Participation in the network must be approved by KFTCI, which requires the support of two-thirds of the member banks. KFTCI also administers Korea's "GIRO," or the commercial electronic clearing house system. Membership in GIRO also requires approval by two-thirds of the member banks. In December 1989, a new electronic banking system which will allow interbank transfers of deposits was established for 13 domestic banks. It now includes 27 domestic banks. KFTCI also administers this system.

To date, no foreign banks have been allowed to join Korea's electronic banking networks although one U.S. bank has had an application pending with KFTCI for two years. By contrast, several new local banks established in 1989 and 1990 were given immediate membership in both the ATM and GIRO networks.

Following are some other issues affecting foreign banks' ability to compete effectively in Korea.

- Local banks have access to government funds, one of the principal means by which they increase their loan portfolios. Foreign banks do not.
- Under the Alien Land Acquisition Act, foreign banks' ownership of commercial and residential premises is extremely restricted, affecting their ability to control costs. While foreign banks may acquire land for commercial or residential purposes with ROKG approval, such approval is granted on the basis of nontransparent criteria and in practice is extremely restricted. Only two of the 14 U.S. banks own commercial premises and three own residential real estate. No foreign bank has been given approval to obtain property for about 10 years.
- When foreign banks access the rediscount window of the BOK, they must meet the same requirement to make 35 percent of their loans to small and medium industries as domestic banks. This is a sufficient disincentive so that foreign banks do not access the rediscount window.

Most significantly, however, U.S. financial services firms point out that given their potential competitive advantage in innovation and technology, the restrictive nature of the financial system is itself a significant constraint on their ability to compete effectively. Further liberalization of the system, as well as the elimination of specific barriers, is necessary if U.S. banks are to receive national treatment.

FINANCIAL MARKET DISCUSSIONS

In the February and November 1990 rounds of Financial Policy Talks, the Department of the Treasury encouraged the Korean Government to liberalize the financial sector, improve market access for foreign financial firms, enhance regulatory transparency and accord national treatment to all market participants. During both rounds of talks, the Koreans reaffirmed their commitment to eventual liberalization and national treatment, but made no specific commitments. Between the February and November talks, the environment for foreign participants in Korea actually deteriorated due to the regulatory problems mentioned earlier. In the absence of clear regulations, especially in foreign exchange activity, many foreign banks have felt compelled to curtail their activity in this area. The mid-1990 decision to introduce tougher sanctions against foreign banks in a regulatory environment which lacks transparency and relies heavily on informal guidance is troubling. This deterioration in the overall environment occurred despite a modest increase in ceilings on CD issuance and an increase in the ceiling on paid-in capital for foreign banks.

At the November 1990 meeting, U.S. officials urged the Korean Government to develop a specific timetable for the implementation of specific liberalization measures discussed during the talks. Unfortunately, the MOF expressed reluctance to develop such a schedule. However, MOF indicated that foreign banks are expected to be allowed to participate in the full range of trust business by mid-1991 and that it would attempt to end discrimination in the call market.

The basic issue of denial of equality of competitive opportunity remains and the prospect for full liberalization and national treatment in the near-term appears slim. Piecemeal increases in permissible activity do not address the fundamental problem. Indeed, such an approach often exacerbates tensions between domestic and foreign banks and gives rise to domestic pressure to clamp down on foreign firms.

Until the Korean Government allows domestic banks to compete in a market environment, fully liberalizes interest rates, and eliminates credit allocation and exchange controls, there is little likelihood of major advances in equality of competitive opportunity for foreign financial service providers in the Korean market. Without those fundamental changes, micromanagement of the financial sector will continue and both Korean consumers and producers, along with foreign banks, will be penalized through inefficiency and discrimination.

The Department of the Treasury will continue to encourage the Korean Government to provide full equality of competitive opportunity for U.S. banks and to liberalize the financial sector.

Following the November meeting, the MOF on November 28 indicated other actions would be taken in 1991 to liberalize the banking sector. These actions or statements of intention include the following: the ceiling on paid-in capital will be abolished; efforts will be made to replace, as much as possible, informal regulatory guidance with transparent regulations; improvement in the interbank call market to eliminate discrimination will be implemented in conjunction with money market reforms; restrictions on the hours of operation of ATMs will be lifted and ATMs will be permitted both inside and on the exterior of bank buildings; easing the criteria for branching will be reviewed in conjunction with the Uruguay Round; and limits on foreign currency lending for foreign banks will be greatly increased. These measures, if fully and promptly implemented, could represent useful steps towards market liberalization and eventual equality of competitive opportunity.

CONCLUSION

Significant denials of national treatment continue, but improvements in access are promised for 1991. Nonetheless, U.S. and other foreign banks face serious discriminatory restrictions on their ability to establish and branch, obtain local currency funding, increase their capital, expand their lending operations, engage in the trust business, and have been denied access to the cash dispenser and electronic funds transfer networks. While foreign banks do enjoy some privileges, existing restrictions on permissible activity and discrimination result in an overall denial of equality of competitive opportunity in the local market. Steps by the Government of Korea to reduce discrimination have generally resulted in reducing privileges formerly enjoyed by U.S. and other foreign banks, while discriminatory restrictions remain. The ceilings on issuance of CDs and paid-in capital have been raised, but remain inadequate.

As a result, the ability of U.S. and other foreign banks to serve or expand their client base has eroded. The ROKG's tight regulatory controls over interest rates, credit allocation and foreign exchange operations apply to U.S. and Korean banks, but particularly disadvantage U.S. banks which could otherwise excel at introducing new financial products and services. Financial Policy Talks, initiated by the U.S. Treasury Department with the Korean Ministry of

Finance, have produced expressions of willingness to address some of these denials of full competitive opportunity. Furthermore, the measures noted above in the November 28 communication from the MOF represent potentially useful measures to begin redressing existing problems. It will be important, however, to ensure complete articulation and follow-up on these and a range of additional significant steps before equality of competitive opportunity is realized.

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*U.S. dollar figures calculated at the following rates:

1989: $1 = 671.46 won AA; 679.60 won YE
1990: $1 = 714.1 won (June 1, 1990)

AA = Annual Average
YE = Year-end

18. Republic of Korea - Securities

SUMMARY

U.S. financial firms do not receive national treatment in Korean securities markets. Foreign securities firms are currently permitted to establish a presence in Korea by opening representative offices. There are eight representative offices of U.S. securities firms in Korea. Foreign securities firms are also allowed to buy up to 10 percent of the equity of a domestic securities firm. No U.S. firm has yet purchased equity in a Korean securities company.

As a representative office, a foreign securities firm can act as a conduit for transmitting information between its offshore branches and its Korean customers. The importance of the representative office has increased as more Korean companies have been permitted to issue bonds in the international market and seek underwriters, and as more Korean institutional investors have been allowed to purchase foreign securities. Foreign representatives appear interested in opening branch offices in Korea to generate income on their own.

In the last five years, the Korean securities markets have grown rapidly, with the government of Korea's encouragement, benefitting from the strong economic growth of over 12 percent per annum during the period and the emergence of an external surplus in 1986. At the end of 1985, the stock market had an aggregate market value of 6.5 trillion won ($7.3 billion)*; it closed 1989 at 95.5 trillion won ($140.5 billion). In the same period, the value of bonds outstanding grew from 12 trillion won ($13.5 billion) to 43 trillion won ($63.3 billion). The government has successfully encouraged businesses to list and raise capital in the market rather than finance primarily through bank loans as they had done in the past. A few of the larger Korean companies also have been permitted to tap the international bond market to raise funds. This rapid growth has attracted the attention of many U.S. securities firms. However, the government's program to internationalize the securities industry is only in its initial stages.

In December 1988, citing unexpected economic changes, the Korean Government revised its original 1981 schedule to liberalize the securities industry. According to the timetable, the government intends to open the Korean market to foreigners and allow Korean individuals to invest overseas (both on a limited basis, with conditions not yet specified) by 1992. In 1990, the Republic of Korea Government (ROKG) plans to announce the criteria for upgrading foreign securities offices from representative status to branch status, and to expand limits on Korean institutional investment overseas. The government envisions foreign branch offices operating in 1991. According to the Ministry of Finance (MOF), the Korean Government will apply national treatment in the securities industry. However, MOF has also cautioned that criteria for licensing U.S. and other foreign securities firms to open branches may be "slightly restrictive," considering the competitiveness of the domestic securities industry. There have been indications that MOF may allow only a few foreign securities firms to open branches in 1991, and that these branches will initially be restricted to a very limited scope of activities.

The Korean Government has not yet given any indication of the criteria which will govern the granting of branch status or what activities the branch offices will be permitted. Given the current lack of transparency, it is uncertain what "liberalization" will actually mean for U.S. or other foreign securities firms in Korea.

The revised 1988 plan actually delays and restricts the market opening plan originally proposed in 1981. Under the 1981 plan, limited foreign direct investment in the Korean securities market was to have been achieved by the mid-1980s, with remaining restrictions to have been removed by the late 1980s; full liberalization of capital movements into and out of Korea was to have been achieved by the early 1990s.

In February and November 1990, the Department of the Treasury held Financial Policy Talks with the Ministry of Finance. During the talks, Treasury emphasized the importance of Korea's adherence to the timetable for capital market liberalization, the need to develop transparent rules and regulations for market entry and permissible activity and the need to accord foreign participants national treatment and the necessity of foreign exchange liberalization to develop fully the capital market. MOF reaffirmed its' commitment to the 1992 liberalization schedule and indicated national treatment and access to brokering, dealing and underwriting activity would be accorded to foreign firms.

While MOF maintains that it is committed to liberalization, significant denials of national treatment exist and no meaningful improvement has occurred.

OVERVIEW

Domestic Securities Markets

The securities markets in Korea have undergone a rapid expansion since the mid-1980s. The Korea Stock Exchange's (KSE) market value has grown from 6.5 trillion won ($7.3 billion) at the end of 1985 to 95.5 trillion won ($140.5 billion) at the end of 1989. The value of bonds outstanding has grown from 12 trillion won ($13.5 billion) to 43 trillion won ($63.3 billion) during the same period.

At the end of 1989, the KSE listed 626 companies, nearly double the number in 1985. Trading averaged 280 billion won ($417 million) and 12 million shares a day in 1989. According to MOF, the turnover ratio of the KSE has been at least double that of the major U.S. and Japan exchanges. The Korea Composite Stock Price Index, which measures aggregate price performance, closed 1989 at 909.72, nearly a 500 percent increase since year-end 1985.

MOF has been the guiding influence behind the KSE's dramatic expansion. MOF also plays a role in the daily behavior of the market; managing the market supply by curbing paid-in capital increases by listed companies and controlling new listings on the exchange, and making credit available to institutional investors during market slumps. There is also a provision in the Korea Stock Exchange's rules that places limits on a stock's daily price movements (3 to 4 percent). Individuals regard the government as influential in the market's behavior. During the market's slide in late 1989 and early 1990, demonstrators demanded government action to halt the decline.

Government attempts to micromanage stock market behavior have contributed to the volatility of stock prices. For example, the government had been forcing companies to go public in order to reduce their reliance on debt financing, which in turn allegedly caused an oversupply of stocks and contributed to the recent stock market decline. The Korean Government has indicated that it will reduce its intervention in the stock market.

Securities and Exchange Act: The major law governing the securities markets is the Securities and Exchange Act (SEA), first enacted in 1962 and revised several times, most significantly in 1976. Under the SEA, the banking and securities businesses are separated. Article 29 of the SEA requires banks and other financial institutions to obtain MOF's approval to engage in the securities business. Article 51 prohibits securities companies from engaging in a business other than the securities business unless approved by MOF.

The SEA established the Securities and Exchange Commission (SEC) which is subject to the supervisory authority of MOF and supervises the securities industry through its executive arm, the Securities Supervisory Board (SSB). Other important institutions in the securities markets are the Korea Securities Dealers Association, the Korea Securities Finance Corporation and the Korea Securities Clearing Corporation.

There are currently 25 Korean securities firms licensed by MOF and operating under the Securities and Exchange Law. No new firms have been licensed in more than 15 years. Membership in the KSE is limited to these companies. Their main activities are brokerage, dealing (trading for the broker's own account) and underwriting. In addition to the securities companies, merchant banks and short-term finance companies have been permitted to engage in restricted underwriting, mainly for government and other public bonds. Currently, there are approximately 100 firms which have received MOF's approval to underwrite securities.

Stocks traded on the main exchange of the KSE are divided into two sections. The major difference between the two sections is that margin transactions are not permitted in the second section. A new listing is initially assigned to the second section for at least six months. After meeting certain criteria regarding the number of shareholders, trading volume, after-tax profits and the payment of dividends, the stock can be moved to the first section. In 1987, an over-the-counter market was established for companies not eligible for the KSE. There are no financial futures or options markets.

The majority of shareholders continue to be individuals, accounting for 70 percent of shares owned, as opposed to institutional investors' 30 percent. The government is concerned about the relative weakness of institutional investors and is now increasing both the number and strength of authorized institutions.

Bond Market: Korea's bond market is divided between government/public and corporate bonds. Bonds are traded on both the main exchange and the over-the-counter markets. Total bond trading averaged 18 billion won ($26.8 million) a day in 1989. About two thirds of Korea's outstanding bonds are government/public, mainly Monetary Stabilization Bonds (MSB) used to control the money supply. There is a lack of variety among corporate bonds: 70 percent are straight discount or coupon bonds with a duration of under four years and guaranteed by a financial institution. There is a small but growing number of convertible bonds and bonds with warrants, both guaranteed and nonguaranteed. Average bond yields in 1989 ranged from 14.4 percent to 15.9 percent.

The major participants in the bond market are institutional investors, mainly the three large securities investment trust companies. Ninety-nine percent of corporate bonds and 94 percent of government bonds are held by institutional investors. Under the regulation of the Securities Investment Trust Business Law, the three investment trust companies and six merchant banks in Korea engage in the investment trust business, packaging securities in beneficiary certificates (similar to mutual funds) and reselling them to individual investors.

Korean companies, traditionally heavily dependent on indirect financing through banks, are increasingly turning to the securities markets. In 1989, corporations raised 21 trillion won ($31.3 billion) through stocks and bonds as opposed to 1 trillion won ($1.1 billion) in 1985. Direct financing in the securities market exceeded bank financing for the first time in 1988.

Until 1980, international securities transactions involving Korean securities or Korean investors were prohibited. In January 1981, the ROKG announced a "Plan for the Liberalization of the Capital Market" which was further elaborated in December 1988. In accordance with the plan, certain international securities transactions have been permitted, subject to MOF's approval.

In November 1981, the Korean Government took the first step toward internationalizing its securities industry by approving indirect foreign investment in the Korean market through the Korea International Trust and the Korea Trust. In 1985, eight additional investment trusts were authorized, including two venture capital trusts. These 10 investment trusts, totaling $295 million in assets, are managed by domestic investment trust companies.

In 1984, the Korea Fund (KF), a closed-end fund managed by a U.S. fund manager, was created under the U.S. Investment Company Act and listed on the New York Stock Exchange with an initial value of $60 million. The KF increased its capital to $100 million in 1986 and again to $150 million in August 1989. A second closed-end fund open to foreigners, the Korea Europe Fund (KEF), was established in 1987 and is listed on the London exchange. As of April 1990, the KEF was capitalized at $110 million. In July 1990, three matching funds, placed both domestically and overseas, and invested in foreign as well as domestic securities, were established, totaling $300 million. As of July 1990, the total level of foreign participation in the Korean securities market through indirect investment vehicles amounted to $1.25 billion. The government also announced in May 1990 its intention to establish a Korea Asia Fund.

Progress Since 1985: Since 1985, Korean companies have increasingly been permitted to issue international equity-related bonds. Samsung Electronics issued Korea's first overseas convertible bonds in 1985. As of April 1990, eight private Korean companies had been authorized to issue convertible bonds in the Eurodollar market in a total amount of $260 million. In September 1989, Sammi Steel was the first Korean company to issue Eurobonds with warrants that can be converted into nonvoting preferred shares. As of April 1990, two Korean companies had issued overseas bonds with warrants, totaling $120 million. In the issuance of these offshore bonds, all but one of the lead underwriters have been foreign concerns; in many cases, an American company has been the lead underwriter.

Since 1989, foreign investors have been allowed to sell the shares underlying convertible bonds under certain conditions after the bonds reach their conversion date. However, foreign investors are not yet permitted to reinvest the proceeds from the sale of such shares in other Korean equities. MOF plans to permit foreign investors to reinvest the proceeds from the sale of converted shares in other equities beginning in 1991.

In July 1988, the government, for the first time, allowed additional domestic institutional investors, besides already qualified commercial banks to invest in overseas securities within specified ceilings. As a result, investment in overseas securities by domestic institutional investors, which totaled $19 million at the end of 1988, grew to $107 million by year-end 1989. U.S. securities companies can act as brokers for Korean institutions interested in buying overseas. However, the representative offices of U.S. securities companies in Korea can only act as a liaison in these trades.

As noted, in accordance with the government's Capital Market Liberalization Plan, in 1990, three matching funds were established to be invested in both foreign and domestic securities and sold both domestically and overseas. The government has relaxed limits on foreign exchange holdings of domestic institutional investors and allowed nonfinancial domestic institutions to invest in overseas securities. In 1991, the government also plans to allow foreign holders of Korean convertible bonds to sell the converted shares and use the proceeds to invest directly in the securities market. This will allow foreign participation without increasing the presence of foreign capital.

The government has stated that it will announce in 1990 the criteria for foreign securities firms, currently allowed only representative offices in Korea, to upgrade their representative offices, to open branches or to participate in joint ventures in Korea beginning in 1991. According to MOF, the Korean Government will apply national treatment in this sector. However, MOF has cautioned that criteria for licensing U.S. and other foreign securities firms to open branches may be "slightly restrictive" (as were the criteria for approving foreign bank branches) considering the competitiveness of the domestic securities industry. There have been reports in Korea that MOF may allow only a few foreign securities firms to open branches in 1991, and that the activities authorized to these branches will be very limited. After approval of branch status, there may be a significant delay until foreign branches are permitted to engage fully in the same activities as domestic companies; namely, brokerage, managing firm's own securities portfolio and underwriting.

It is not yet clear whether liberalization of Korea's securities markets in 1991 will include opening the investment management business to foreign firms. One U.S. investment management firm has expressed concern over its inability to open a representative office even though it has pursued an application with MOF since 1987.

In 1992, individual Koreans will be allowed to purchase overseas securities and foreigners will be allowed to invest directly in the Korean securities market within limits yet to be specified.

Following the economic slowdown in 1989 and the stock market's decline in early 1990, there were indications that some rethinking of the commitment to open the capital market in 1992 was underway. However, the government has reiterated it plans to adhere to the 1992 target date.

U.S. Presence in the Market

Entry and Establishment: Article 17-2 of the Enforcement Decree of the SEA permits the establishment of a branch office of a foreign securities firm in Korea subject to certain criteria and with MOF's approval. However, current MOF policy has limited foreign presence to the establishment of representative offices. As of June 1990, there were eight licensed representative offices of U.S. companies engaged in the securities markets out of a total of 24 foreign securities firms present in Korea.

To establish a representative office in Korea, a foreign securities firm must submit a letter of intent to MOF. The criteria for receiving MOF's approval to open a representative office in Korea are not publicly available. However, MOF has indicated that there are certain factors which influence the granting of a license.

The standing, size and reputation of the firm in the securities industry are taken into account. The firm's participation with Korean firms overseas as well as its contribution to the Korean market are also weighed. There is also a reciprocity requirement that ensures that Korean securities firms are adequately represented in the foreign company's home country. This is not presently an issue for U.S. companies since the number of Korean securities representatives in the U.S. outnumbers American firms in Korea. For purposes of reciprocity, the nationality of a securities company is considered to be that of the major shareholder. Prior to the adoption of this policy, the country of incorporation was the deciding factor. Once a year, usually in August or September, MOF reviews the letters of intent and invites qualified companies to apply for a license. After reviewing the applicants' financial statements, MOF issues a license to the foreign firm to operate a representative office in Korea.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Until recently, most U.S. securities companies have found the process of establishing a representative office to be straightforward, taking less than six months to complete. However, one U.S. firm which applied in early 1989 for a license to open a representative office of an overseas securities subsidiary is still working with MOF to gain entry.

Under the Foreign Capital Inducement Law, a foreign securities firm also may purchase up to 10 percent of a Korean securities company. Total foreign equity in a Korean securities firm may not exceed 40 percent. No U.S. company has purchased equity in a Korean securities company, but three non-U.S. foreign firms have purchased equity in two Korean securities companies as of year-end 1989.

Operations: Due to its rapid transformation since the mid-1980s, the Korean securities market, as well as the government's attitude toward it is in a state of flux. MOF has announced general policy aims for the future of the securities industry, but maintains an ambiguity that allows it the freedom to make changes. In many instances, policies currently governing the activities of foreign securities firms represented in Korea are neither published nor transparent.

In licensing foreign representatives, MOF authorizes only liaison activities, i.e., the exchange of information with the home office. Representative offices may not engage in domestic securities-related business in Korea directly, including direct investment in the stock market. No income can be generated by the representative office. Representative offices are not permitted to accept a commission for any of their activities.

Representative offices conduct research and perform services, acting as sales agents for their parent companies. They identify clients needing international financial and investment banking services and customers interested in international investment instruments, and refer them to branches outside Korea. Activities include identifying offshore underwriting that will eventually be booked by another branch outside of Korea or selling paper underwritten by the head office. Representative offices also sell foreign securities to the Korean institutional investors that are permitted to invest abroad, and serve as conduits for Koreans permitted to borrow in the international capital market.

U.S. financial institutions authorized to purchase Korean bonds must do so through the Korean Stock Exchange. This requirement does not apply to Korean institutions. U.S. purchasers must, therefore, pay the higher commission associated with dealing through a Korean company with a seat on the exchange, and cannot participate in the sizeable bond trading activity that occurs after the exchange is closed.

FINANCIAL MARKET DISCUSSIONS

In February and November 1990, the Department of the Treasury held Financial Policy Talks with the Korean Government. The talks addressed financial market liberalization, including opening of the capital market, improved access for U.S. financial institutions, exchange controls, the provision of national treatment to firms established in Korea, the need to enhance transparency in regulations and the utility of moving closer to international accounting standards.

During the talks, Treasury emphasized the importance of Korea's adherence to the timetable for capital market liberalization, the need for early announcement of and the opportunity for public comment on the criteria permitting broad entry into the Korean capital market by U.S. financial institutions and individuals, the necessity of foreign firms obtaining access to seats on the KSE and the need to liberalize the exchange control regime in order to achieve internationalization of Korea's capital market. In the November talks, MOF reaffirmed the government's commitment to the 1992 target for liberalizing the capital market, indicated it would develop criteria before the end of 1990 for the establishment of securities firms in Korea by foreign firms and seek public opinion on those criteria, and national treatment and access to brokering, dealing, underwriting and the over-the-counter market would be accorded to foreign firms. Since the KSE is a private organization, MOF could not assure Treasury officials that foreign firms would be able to gain seats on the exchange.

Following the November talks, the MOF released draft criteria for the establishment of branches and joint ventures by foreign firms. Those criteria appear excessively restrictive.

CONCLUSION

Significant denials of national treatment exist and no meaningful improvement has occurred. To date, the government's steps toward liberalization have been aimed at allowing Korean financial institutions greater freedom to exploit opportunities in the United States and other foreign capital markets. The government of Korea's December 1988 revised plan for liberalizing its capital markets delayed until 1991-1992 the important steps of licensing U.S. and other foreign securities firms and allowing foreign financial institutions and individuals direct access to the Korean equities market. (The government's original 1981 liberalization plan had envisioned completing these steps by the late 1980s.) Draft criteria for licensing U.S. and other foreign securities firms released in late November appear highly restrictive, as are existing criteria for approving new foreign bank branches. Moreover, important questions, such as equity composition and permissible activities, remain unanswered at this time. Observers fear that the range of permissible market opportunities may also be severely limited when foreign securities firms and other investors are allowed to participate directly in Korea's capital markets. Expansion of the closed-end equities funds, such as the Korea Fund, is a welcome development but does not constitute a significant improvement in foreign access to Korea's equities market. However, if the Korean Government carries through with the measures cited during the November 1990 Financial Policy Talks and the final criteria for establishment are appropriately adjusted, important improvements may be introduced over the next two years.

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*U.S. dollar figures calculated at the following rates:

1985: $1 = 870.02 won AA; 890.20 YE
1989: $1 = 671.46 won AA; 679.60 YE

AA = Annual Average
YE = Year-End

19. Mexico - Banking

SUMMARY

Mexico is closed to foreign bank entry with the exception of one grandfathered bank which is greatly restricted in the types of operations it can carry out. The Mexican economy has opened considerably over the past three years with greater trade and investment opportunities for foreigners. There has been some opening of the banking sector as well. As a result of legislation passed in July 1990 Mexican commercial banks are being privatized and foreigners will be allowed to own up to 30 percent of the voting stock. Furthermore, changes in financial regulations enacted in 1989 allow considerable foreign participation in other parts of the financial sector. This is reported to be a prelude to additional relaxation of entry restrictions in the future.

Banking in Mexico is highly consolidated with only 20 commercial banks in 1990 versus about 200 banks in 1975. The two largest banks dominated the industry in the 1980s. The industry was heavily regulated by the financial authorities, but in 1989, the degree of control was reduced, allowing commercial banks to set interest rates and reduced obligatory lending to the public sector.

Competitive opportunities for the only foreign bank in Mexico (Citibank N.A.) are greatly restricted because of official prohibitions against expansion of its offices and its confinement to deposit bank activity in a competitive multiple-service banking structure.

In December 1989, some portions of the nonbanking financial sector were opened to minority foreign participation. Foreigners may now own up to 49 percent of companies engaged in insurance, leasing, bonding, factoring, and warehousing. At that time the Government also authorized the issuance of new nonvoting shares of the banks. This has since been replaced by the law of July 1990, which permits up to 30 percent foreign ownership of the voting stock.

Despite steps to permit limited minority foreign investment in Mexican banks, significant denials of national treatment continue with only slight improvement foreseen. The U.S. Treasury has raised concerns about Mexico's denial of equality of competitive opportunity in both banking and securities with the Mexican authorities, and will continue in the negotiation of a Free Trade Agreement with Mexico.

As of year-end 1989, Citibank, the only foreign bank allowed to operate in Mexico, operated five branches with assets of $335 million. Two U.S. banks in Mexico operated a total of five subsidiaries with assets of $298 million. Forty-five U.S. banks maintained representative offices in Mexico at year-end 1989, a decline of four from year-end 1985. While this presence represents an increase in Citibank's assets, it represents a net decrease of $232 million in total U.S.-owned assets since year-end 1985. At that time, Citibank had five branches with assets of $140 million and U.S. banking corporations reported interests in eight subsidiaries or affiliates in Mexico, with total assets of approximately $725 million.

At the end of 1989, six Mexican banks in the United States operated 12 agencies with assets of $3.9 billion and two subsidiaries with assets of $840 million. Mexican banks maintain seven representative offices in the United States. This presence represents an increase of three agencies and of $892 million in assets since year-end 1985. At that time, six Mexican banks operated a total of nine agencies in the United States, with total assets of $3.4 billion. Four Mexican banks maintained representative offices in the United States. Further, Mexican banks reported majority ownership in two U.S. banks with a total of 14 branches and aggregate U.S. assets of $417 million.

OVERVIEW

Domestic Banking Market

The creation of the Bank of Mexico (the Central Bank) in 1925 was the first step in the formation of the country's banking system. In 1941 the law on credit and auxiliary institutions established the original framework for the operation of Mexican banks. This law required credit institutions to specialize as deposit banks, savings banks, financial societies, mortgage banks, fiduciary institutions or capital societies. In 1976, banking rules were changed in Mexico to permit universal banking operations. Commercial banks, investment banks, mortgage banks, savings banks and other financial institutions were allowed to merge their separate services under one roof in order to provide additional services more efficiently. This also allowed the banks greater flexibility and promoted the introduction of new instruments such as certificates of deposit and bankers acceptances.

Commercial Banks: Mexico's privately owned domestic commercial and investment banks were nationalized in September 1982. The nationalization had a profound and immediate negative impact on savers and investors. However, legislation passed in July 1990 will lead to the reprivatization of the banks in the near future.

There has been a major consolidation of commercial banks. In 1975, there were nearly 200 banking institutions in Mexico. When the banks were nationalized in September 1982, the number was reduced to 59. By early 1990, there were 18 nationalized banks, plus two banks which were not nationalized (Banco Obrero and Citibank). This consolidation was taken in order to increase efficiency and reduce operating costs in the banking system and to continue the trend begun in the mid-1970s toward increased concentration of services. The remaining banks (national credit societies) offer a full array of deposit-taking instruments as well as longer term lending, mortgage financing, and trust services.

Under the new law to privatize the banks, voting shares are divided into three categories: series A, series B and series C. Series A shares, which constitute 51 percent of each bank's voting shares, must be held by Mexican individuals or entities, including the Federal Government. Series B shares, which represent up to 49 percent of the total, can be owned by those eligible to acquire type A stocks plus Mexican companies that are not directly or indirectly controlled by foreigners, Mexican insurance and bonding companies, investment societies, pension funds and other institutional investors approved by the Ministry of Finance. Type C shares, which can represent up to 30 percent of the paid in capital, can be issued only with Ministry of Finance approval. These stocks can be acquired by those qualifying to purchase B stocks, all other Mexican companies and citizens, and foreigners who are not government or official entities. No individual or company may obtain directly or indirectly more than 5 percent of the paid-in capital of any Mexican commercial bank. In some cases, the Ministry of Finance can make an exception, allowing up to 10 percent ownership.

Mexican commercial banks reported in November 1989 total assets of $52.7 billion, of which loans constituted $36 billion. About 50 percent of total deposits are in the two largest banks, Bancomer and Banamex, and the next three largest banks (Comermex, Serfin and Internacional) account for an additional 25 percent of the total. Mexican commercial banks are divided into three types, national, multiregional and regional. The six national banks are permitted to open branches anywhere in Mexico. Their charter is to provide financing for large investment projects in the social and private sectors, finance and strengthen foreign trade operations, and promote the development of technological innovation. The eight multiregional banks are concentrated in the nation's largest production and consumption centers. These banks offer integrated financial service packages primarily to industry and business. Regional banks are intended to help implement the Government's strategy of encouraging decentralized economic activity by concentrating their resources on business in the regions in which they operate.

Development Banks: In addition to the commercial banks, there are seven Mexican development banks which reported $42.2 billion in assets as of November 1989, of which $31.7 billion was in the form of loans. Development banks are government-owned specialized financial institutions designed to help implement national investment plans. Their principal means of obtaining resources traditionally have been federal government transfers and foreign borrowing. The banks are beginning to redefine their roles, reducing the level of subsidized credits granted to special sectors, while continuing to provide technical assistance and channeling funds through the commercial banks. By far the largest development bank is Nafinsa, which in 1989 redefined its strategy from one supporting public sector enterprises to one of supporting the private and social sectors. It has reduced its role in direct financing of projects by providing funds through the commercial banks instead. However, Nafinsa will continue to act as the agent of the Federal Government for the international financial institutions. Furthermore, since mid-1989 other development banks have also acted as second tier institutions, concentrating on technical assistance and rediscounting documents from the commercial banks, thereby allowing these banks to provide more credit.

Assets and Liabilities of Mexican Commercial Banks
(Billions of Pesos)

	1986	1987	1988 1/	1989 2/
Total Assets	33,637	78,566	105,460	101,323
of which				
liquid	6,304	9,489	10,916	7,982
securities	4,234	11,274	24,173	19,730
loans	1,172	53,070	64,864	67,850
other	1,927	4,733	5,507	5,761
Total Liabilities	33,637	78,566	105,460	101,323
of which				
monetary	2,534	5,060	7,384	6,436
non-monetary	29,146	68,303	87,889	84,128
other liabilities	1,325	3,098	6,103	6,311
capital	632	2,105	4,084	4,448

Assets and Liabilities of Mexican Development Banks
(Billions of Pesos)

	1986	1987	1988 1/	1989 2/
Total Assets	33,884	85,259	102,159	103,884
of which				
liquid	476	1,127	1,207	1,849
securities	586	2,130	5,270	4,931
loans	25,834	66,148	77,941	77,630
other	6,988	15,854	17,741	19,474
Total Liabilities	33,882	85,259	102,159	103,884
of which				
monetary	92	172	268	284
nonmonetary	32,414	82,351	94,614	94,803
other liabilities	835	1,804	3,569	4,042
capital	541	932	3,708	4,755

1/ Data are for end of period
2/ 1989 Data through April

Note: peso/dollar exchange rates, end of period:
1986: 923 pesos =$1
1987: 2,198 pesos =$1
1988: 2,257 pesos =$1
1989: 2,389 pesos =$1

Recent Developments: The Mexican banking system is highly regulated, although the degree of regulation was sharply reduced in 1989 and again in 1990 with the law to reprivatize the banks. In April 1989, banks were permitted to establish, independently, interest rates for traditional savings accounts; previously the rates had been established by the monetary authorities. At the same time, the required reserve was sharply reduced. In 1988 and early 1989, the required reserve had been effectively 100 percent due to the combination of a cap on lending to the private sector and required lending to the public sector. The required reserve (to be held with the Central Bank) has been eliminated, but banks are required to place 30 percent of their deposits in government financial instruments. These changes have allowed the banks to compete more effectively with other financial institutions in Mexican financial markets.

Because of the restrictions, traditional banking accounted for only about 29 percent of financial activity in 1988 versus about 64 percent of such activity in 1987. In that period, much of the financial activity shifted to the money market, dominated by brokerage firms, and to less regulated banking activities, principally bankers' acceptances. With the liberalization in 1989, some of this activity shifted back to the traditional banking sector.

A number of financial sector reforms were implemented in December 1989. Foreigners are now permitted to hold up to 49 percent interest in insurance, factoring, warehousing, and bonding companies. Foreign investors already had permission to own 49 percent of leasing companies.

The same legislation and the new banking legislation permit the formation of financial holding groups. Banks can join with leasing, warehousing and factoring firms, exchange houses, and mutual funds as well as with brokerage or insurance firms. A third modification under the 1989 regulations granted commercial banks greater autonomy from the Ministry of Finance in forming their operating plans and appointing senior officials.

PRESENCE AND TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Mexican law prohibits foreign bank entry into full-service banking. U.S. banks do not enjoy market access or right of establishment. They are denied national treatment. Citibank is the only foreign-owned bank that offers domestic financial services, although its share of the domestic banking market is minuscule. It owes its position in Mexico to a clause that grandfathered the presence of foreign-owned banks previously established in Mexico. Forty-five U.S. banks maintain representative offices in Mexico.

Citibank is constrained by Ministry of Finance policy from opening new offices or becoming a multiple-service (universal) bank. Unlike national banks, it may only accept demand deposits, for which it cannot pay interest. Citibank may not accept time deposits. It has not been allowed to establish additional branches beyond its five grandfathered branch offices in Mexico City, limiting its ability to offer nationwide service. These restrictions limit Citibank's competitiveness against major Mexican banks, which offer a greater range of services and provide nationwide networks.

Several U.S. bank holding companies have minority interests in financial leasing companies, often held jointly with Mexican banks. Some have found that being limited to a minority position is unsatisfactory, and few banks are currently interested in entering joint ventures in leasing or the newly opened financial fields if they are limited to 49 percent ownership.

Prospects for Opening the Banking Sector: Since 1986, when it joined the GATT, Mexico has rapidly opened its economy. Most notable is the sharp reduction of import restrictions in December 1987 and new regulations, promulgated in May 1989, permitting 100 percent foreign ownership in many industries, provided certain criteria are met.

This opening should now begin to include the banking sector, which has been opened to minority foreign participation. Financial authorities have indicated that economic modernization will require an internationally competitive financial sector open to foreign participation. Hopefully the banking sector might be opened to greater foreign participation in the near future.

Privatizing the banking sector should enable domestic banks to better compete with foreign banks and may yield an avenue for greater foreign participation. The reduced regulation of the domestic banks will increase competition among the banks, promoting greater efficiency in the domestic banks, which would make them more competitive should the sector be opened to foreign banks.

Nonbank Financial Institutions: Nonbank financial institutions in Mexico include general warehouses, bonding companies, financial leasing companies, credit unions, factoring companies, exchange houses, insurance companies and investment societies. Warehouses receive merchandise and issue bonds or certificates of deposit that can be rediscounted in the secondary market to provide working capital. Bonding companies post bonds to guarantee the fulfillment of a civil or commercial obligation (these have been used primarily to guarantee projects contracted with the Government). Financial leasing companies help to reduce initial investment costs for companies by leasing capital goods with an option to purchase. Until recently many of these companies have struggled because many of their resources came from foreign borrowings and their debts had to be restructured after the peso devaluations of the early 1980s. Credit unions have been most active in the agricultural sector, providing credits to common land farms (ejidos) and fishing cooperatives. Factoring institutions collect accounts receivable for companies that have provided suppliers credit. Exchange houses have been in existence in Mexico since 1983, buying and selling foreign exchange. The insurance industry has been highly regulated and was closed to foreign companies until this year. A few companies have dominated the relatively small market; however, the authorities hope that recent liberalization will make the sector more competitive.

FINANCIAL MARKET DISCUSSIONS

Concerns about Mexico's denial of equality of competitive opportunity have been raised with the Mexican authorities in meetings with government officials during periodic visits to Washington.

Right of establishment and equality of competitive opportunity in both banking and securities will be topics of interest to Treasury in negotiation of a Free Trade Agreement with the Mexican Government. Opening Mexico's financial services market to foreign competition would be an important step in enhancing efficiency and establishing sensitive market barometers that will help ensure sustained growth in this important trading partner of the United States.

CONCLUSION

Despite steps to permit limited minority foreign investment in Mexican banks, significant denials of national treatment continue with only slight improvement foreseen. Mexico has been closed to foreign entry since the 1930s. The nationalization of the Mexican banking industry in 1982 reinforced barriers to direct entry. Legislation is now in effect which will permit majority ownership of commercial banks by the private sector. As part of this reprivatization program, foreign investors as a group will be allowed to own up to 30 percent of the banks to be privatized. However, this legislation will not permit meaningful foreign bank establishment and operational activity. Banks tend to conduct international activity through branches and wholly owned subsidiaries. Therefore, it remains to be seen if any U.S. banks will be interested in the Mexican privatization program given the remaining limitations on foreign ownership and control.

20. Mexico - Securities

SUMMARY

The securities market in Mexico is very active, but trading is concentrated in the short-term money market, particularly in government instruments. Because of high inflation and economic uncertainties, investors have a preference for short-term liquid instruments. Trading in instruments with maturities of less than one year accounts for over 80 percent of the market's activity. In contrast, the stock market is much smaller and less active. It accounts for less than 5 percent of financial market trading, and the level of stock market capitalization is relatively low, at about 13 percent of gross domestic product (GDP).

Foreigners may purchase most financial instruments, either directly or indirectly. Since November 1989, foreigners have been able to purchase equity of any company traded on the Mexican Stock Exchange, but most surrender the voting rights to a trust managed by Nafinsa (the National Development Bank). Foreigners' ability to purchase voting stock is severely limited, since some types of stocks are closed to foreigners, and many of those which are available to foreigners are already closely held by multinationals. However, instruments which are not directly available to foreigners (including Treasury bills, which cannot be acquired directly by nonresidents of Mexico) are available through mutual funds.

In December 1989, some portions of the nonbanking financial sector were opened to minority foreign participation. In July 1990, legislation was enacted that permitted minority foreign participation in banks up to 30 percent.

Foreign firms may not offer brokerage services, however, since majority ownership of brokerage firms as well as banks and other financial intermediaries is limited to Mexicans. Foreign commercial and investment banks are not allowed to establish branches or subsidiaries although they may open representative offices.

Significant denials of national treatment exist in Mexico. The Treasury Department has raised national treatment issues with the Mexican authorities and will continue to do so in the negotiation of a Free Trade Agreement with Mexico.

OVERVIEW

Domestic Securities Markets

Mexico has one securities exchange market, the Bolsa Mexicana de Valores, which trades stocks and other securities. The Bolsa, in one form or another, dates back to 1895.

However, the law governing the issuance of private and public securities and the regulations pertaining to the stock brokerage houses were only enacted in 1975. Furthermore, the market did not really begin to expand until the late 1970s, with the introduction of Treasury bills, unsecured corporate bonds, a centralized deposit institution (Indeval) and greater power for the regulatory agencies.

The Bolsa is regulated by the Comision Nacional de Valores (CNV) a semi-autonomous agency of the Ministry of Finance that is loosely modeled after the U.S. Securities and Exchange Commission. The Ministry of Finance and the Central Bank (Banco de Mexico) also have important regulatory powers. Indeval takes physical custody of all securities issued by the Government and private sector agents and keeps accounting records regarding ownership.

Mexico has about 25 brokerage houses which conduct most transactions, although banks also buy and sell financial paper. All the brokerage firms are majority Mexican-owned; foreigners may now own up to 30 percent of these companies. However, individuals cannot own more than 10 percent of the paid in capital.

Government Instruments: Financial market activity is dominated by government issues. The Government has run sizable public sector deficits (12.3 percent of GDP in 1988 and 6.4 percent of GDP in 1989) and has been borrowing less on foreign markets in recent years. Therefore, it has had to borrow heavily in the domestic markets, where its presence and very high interest rates (40-47 percent nominal interest rates in the first quarter of 1990) have, until recently, largely displaced private sector borrowers from the market.

The principal government instrument is Treasury bills (Certificados de Tesoreria -- Cetes). The most common term is 28 days, and the yield on 28 day bills serves as a bench mark rate for the financial markets. Between 1978 and 1982, interest rates on Treasury bills were fixed by the Mexican Government, but since 1982 an auction system has been used so that interest rates are determined by market forces. In January 1990, trading of Treasury bills constituted 93.6 percent of trading in short-term instruments (with maturities of less than one year). In turn, the short-term money market has dominated the entire securities market, accounting for about 88 percent of all trading. In part, this predominance reflects the well-developed secondary market for Treasury bills, a market that is lacking for other money market instruments.

The modern Mexican money market was largely created by the introduction of Treasury bills in 1978. In introducing them, the Government was seeking an alternative to the banking system as a means of borrowing. Treasury bills took on increased importance during the 1980s, as the Government reduced its reliance on the banking system for financing. Furthermore, Treasury bills have been the principal instrument by which the Central Bank controls short-term liquidity, through purchases and sales in the secondary market.

Treasury bills are sold at a discount, with their yield determined by the discount rate, and are auctioned weekly by the Central Bank on behalf of the Ministry of Finance. Individuals (residents of Mexico only) may buy Cetes through banks or brokerage firms. However, the vast majority of Treasury bills (and other government paper) is purchased by banks and brokers for their own accounts, primarily for mutual funds.

The two other short-term government instruments are both coverage or hedge instruments. Pagafes (Pagare de la Tesoreria de la Federacion) and Tesobonos (Bonos de la Tesoreria) are denominated in U.S. dollars but payable in pesos. The principal difference between the two is that Pagafes are converted at the controlled exchange rate, while Tesobonos are converted at the free market rate. (During September 1990, the free rate averaged about 0.1 percentage points higher than the controlled rate.) These bills pay a lower yield than peso-denominated instruments because of the protection they offer against a devaluation. The market for these instruments is small (0.4 percent of trading in January 1990), but demand rises in times of uncertainty.

As in the money market, the long-term (more than one year) securities market is dominated by government issues. It is much smaller, making up only 10.3 percent of trading in January 1990. In 1989, however, there was considerable growth in one and two-year government bonds (Bonos de Desarrollo -- Bondes). First issued in 1987, it was not until inflation reached relatively low levels in 1989 that they were widely accepted. The level of trading of bonds is much lower than Treasury bills since the secondary market for bonds is not as developed or popular as that for Cetes.

Bonds pay interest based on the average monthly yield for 28 day Cetes. Since they are usually sold at a discount from par, they pay a premium over the Treasury bill rate. Like Treasury bills, they are sold at a weekly auction by the Central Bank.

A second long-term government instrument is inflation-adjusted bonds, Bonos Adjustables (Ajustabonos), with maturities up to three years. The bonds pay a fixed monthly interest rate that is significantly lower than nominal Treasury bill rates, but the nominal value of the bonds are adjusted by consumer price inflation. Ajustabonos are auctioned monthly.

There are several additional government bonds trading on the market, although there have been no new issues in several years. Petrobonos have a par value based on the price of oil, and pay either a fixed interest rate or an adjustable rate several percentage points above LIBOR. Bank indemnity bonds were issued to compensate shareholders in the banks that were nationalized in 1982. The last of these bonds will mature in 1992. Urban renovation bonds were issued to compensate landowners whose property was confiscated following major earthquakes in 1985. The last bonds mature in 1995.

The development of a market for longer-term government instruments has reduced the Government's vulnerability to short-term market movements. The average maturity of the Government's internal debt rose from 16 days in December 1987 to 235 days in November 1989.

Private Sector Financial Instruments: While the financial market is dominated by public sector borrowing, it also is an important source of financing for the private sector. Its importance grew in 1984, when the Government privatized the brokerage services of the banks, which had been nationalized in 1982. It took on even greater importance in 1988, when lending by the banks was capped as an anti-inflation measure. The private sector then turned to the securities market, meeting its financial needs through commercial paper and bankers acceptances. With deregulation of the banks in 1989, there has been a greater balance between the two sources of private sector financing, but securities remain important.

The Mexican financial market has not had a rating agency, such as Standard and Poor's, with the incongruous result that at times a more financially sound corporation will pay higher interest rates than a less sound corporation. A rating agency was founded in early 1990, but has yet to establish a presence. With greater deregulation, credit analysis will take on increasing importance.

The principal source of domestic private sector financing is short-term commercial paper, typically 28 days. Commercial paper made up 5.9 percent of trading in the money market in January 1990. Listed commercial paper, placed through the formal securities market (Bolsa) may only be issued by companies that are already listed on the stock exchange. Brokerage firms normally place the paper, but only banks may offer a guarantee (Aval) for the repayment of the issue. There is also a large market for over-the-counter (OTC) commercial paper (Papel Comercial Extrabursatil) in which the paper is traded directly between a borrower and lender without being placed on the Bolsa. The size of the OTC market is unknown, but is generally believed to be quite large compared to commercial paper traded on the exchange. Brokerage houses are required to report transactions they undertake but sometimes the exchange is arranged informally between two companies.

Commercial paper typically pays a higher yield than other money market instruments, and OTC paper pays an even higher yield. The market for these instruments is considerably smaller than that of Treasury bills. In part, this is because mutual fund managers are reluctant to trade these high-yield instruments once they have obtained them.

A second source of private sector financing is bankers acceptances. These take two forms: bankers acceptances are issued to either guarantee a specific loan for a client, or as a means for a bank to raise funds for its own unspecified lending. Bankers acceptances were widely used in late 1988 and early 1989 because of restrictions on more traditional bank loans. With the lifting of these restrictions in 1989, the use of bankers acceptances has fallen markedly.

The market for private sector bonds is limited. There are two basic types of bonds: unsecured (quirografarias) and subordinated. Interest rates usually are fixed every one to three months, at a premium over the short-term Treasury bill rate.

Use of long-term corporate bonds fell following a change in the tax law in 1986 that eliminated the deduction of the inflation component of interest payments. The inflation component of interest rates compensates for the loss in principal due to inflation. With very high inflation rates, a substantial portion of the principal borrowed had, in effect, been tax deductible until the change in regulations.

Stock Market: Since the stock market deadline in October 1987, when the stock index fell almost 75 percent, Mexican stock prices have risen rapidly. In both 1988 and 1989, the index increased by almost 100 percent in nominal terms. However, trading on the stock market is light. There are only about 250 stocks listed on the exchange, and for most firms only a small portion of their stock is traded on the exchange. Most corporations in Mexico are controlled by either families or multinationals, who prefer to retain their shares. In general, companies meet their financial needs from internal cash flow or borrowings.

In January 1990, only 2.3 percent of trading activity in the securities markets was in stocks. From October 1987 to early 1990, there has been virtually no new issuance of stocks. In general, this reflects the low stock prices following the October 1987 decline. Prices have recently risen to a level that corporations may now consider issuing new stock provided that the issue price for new stock is above the book value price. Stocks are purchased and sold through brokerage firms.

Mutual Funds: There are a large number of mutual funds available in Mexico. They are divided into either fixed-income funds, which invest in money market instruments, and stock funds, which must have at least 50 percent of their assets in stocks. Funds may specialize in particular fields or instruments. Mutual funds are registered as corporations, structured as open-ended funds and sell shares to investors. Most funds are operated by brokerage firms or banks.

Exchange Cover: Exchange rate cover was introduced in 1986 to help exporters and importers insure the future exchange rate that would pertain to their commercial transactions. Activity in this market has been limited so far, in part because of greater predictability of exchange rate policy since 1987. Exchange rate cover can be obtained for up to 180 days.

PRESENCE AND TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Mexico has a multiple-service banking structure. Both domestic and foreign banks are permitted to engage in securities activities indirectly by using Mexican brokerage houses. However, foreign banks must pay the brokerage houses higher commissions than domestic banks.

Foreigners may directly purchase most public and private sector financial instruments, with the exception of Treasury bills (Cetes). However, these as well as other instruments may be purchased through fixed-income mutual funds. Individual foreigners or Mexicans may purchase shares in mutual funds up to 10 percent of the fund. Total foreign ownership of a fund may not be greater than 49 percent.

Foreign purchase of stock is more complicated. Some industries are reserved for the state or Mexicans, and foreign participation in certain other sectors is limited to 49 percent. For example, in December 1989, some parts of the nonbanking financial sector were opened to minority foreign participation. Foreigners may now own up to 49 percent of some financial intermediaries, such as those companies engaged in insurance, leasing, bonding, factoring and warehousing.

Many corporations listed on the stock exchange have shares that foreigners may purchase (usually known as series B shares), but many of these shares are tightly held by joint venture partners. Therefore, there are limited opportunities for foreigners to purchase stock themselves in the stock market. However, foreigners may easily invest in the stock market through stock mutual funds or through the neutral trust concept, i.e., surrendering the stock voting rights to a trust managed by Nafinea.

Majority ownership of brokerage firms is limited to Mexicans although foreigners may own up to 30 percent of the voting stock. As a result of July 1990 legislation, foreign ownership of up to 30 percent of the voting stock of banks is also permitted. Nevertheless, foreign financial firms may not offer brokerage services since they are not allowed to establish branches or subsidiaries and majority ownership of brokerage firms, banks and other financial intermediaries is limited to Mexicans. Foreign financial firms may, however, open representative offices.

FINANCIAL MARKET DISCUSSIONS

Concerns about Mexico's denials of equality of competitive opportunity have been raised with the Mexican authorities in meetings with Treasury officials during periodic visits to Washington.

Denials of national treatment in both banking and securities will be key topics of interest to Treasury in the negotiation of a Free Trade Agreement with the Mexican Government. Opening Mexico's financial services market to foreign competition will be a major Treasury objective in the negotiations. Given Mexico's decade-long policy of denying establishment and national treatment to foreign financial firms, it would be premature to predict the outcome of these negotiations.

CONCLUSION

Significant denials of national treatment exist in Mexico. Foreign commercial and investment banks may not establish branches or subsidiaries, although they may open representative offices. They may only engage in securities activities by purchasing a minority ownership of a brokerage firm or bank or by using a local Mexican brokerage firm. Foreigners are, however, allowed to purchase most public and private sector instruments, but have limited opportunities to purchase stock directly, although they may do so indirectly through mutual funds or trusts.

21. Singapore - Banking

SUMMARY

Singapore is a small economy with a large financial sector. The services sector of the economy accounted for almost 30 percent of gross domestic product (GDP) in 1989. Foreign banks have a large market share of the Singapore dollar portion of the sector and dominate the offshore and foreign currency markets. For domestic political reasons, and perhaps for genuine fear of predatory pricing that would squeeze domestic banks, the Government of Singapore (GOS) implemented regulatory policies that sharply limit foreign banks and protect Singapore banks in the retail Singapore dollar market. The GOS does not issue new full banking licenses and prevents foreign banks from opening new branches or automated teller machines (ATMs), joining existing ATM networks or forming new ones, and introducing new products or services that would give them a competitive advantage over the local banks.

Thus, there are significant denials of national treatment in the domestic market, and no improvement has been made.

At year-end 1989, there were four U.S. financial institutions with full banking licenses, one with a restricted license, and 13 with offshore licenses operating in Singapore. These institutions operated 21 branches with assets of $11.7 billion and 19 subsidiaries with assets of $1.1 billion in Singapore. This represents a decrease of one offshore institution and of $4.1 billion in assets since year-end 1985.[1] At that time, U.S. banks operated 25 branches with assets of $16 billion and 18 subsidiaries with assets of $972 million. U.S. banks also operated 12 merchant banks and five representative offices at year-end 1985. Assets of U.S. banking branches and subsidiaries in Singapore totalled nearly $17 billion.

At the end of 1989, five Singaporean banks operated seven agencies with assets of $434 million and two branches with assets of $170 million in the United States. This presence represents a net increase of one operating office and of $464 million in assets. At year-end 1985, five Singaporean banks operated two branches and six agencies in the United States with total assets of $140 million.

OVERVIEW

Domestic Banking Market

Singapore is a tiny country of 2.7 million people with a moderate gross national product of SD 56.3 billion ($28.9 billion).* The services sector is the largest sector of the economy, accounting for almost 30 percent of GDP in 1989. The sector has averaged 15 percent real growth annually the past three years, while the financial services sub-sector has averaged 27.3 percent real growth annually during the same period.

GOS officials characterize Singapore as "overbanked" in discussing the regulatory environment and their policies toward foreign banks. On this 222 square mile island are 290 financial institutions with 638 branches. Among them are 137 commercial banks (with 275 branches) that can participate in Singapore dollar transactions. All but 68 branches belong to the 13 Singaporean banks.

The type of license a bank holds determines the services it can offer and the extent of its operations. Thirty-six of the 137 banks in Singapore hold "full" licenses, which permit them to offer a complete range of banking services. There is no monetary limit on their Singapore dollar lending activities, although they must get the permission of the Monetary Authority of Singapore (MAS), the Central Bank and financial sector regulatory body, before opening new branches or relocating existing ones. The MAS has not allowed a foreign bank to open a new branch since 1974.

"Restricted" licenses, introduced in 1970 to stimulate the financial sector, are held by 14 of the 137 banks here. To keep them from being fully competitive with local banks, restricted banks can have only one main branch, cannot offer general savings accounts, and cannot accept fixed interest-bearing deposits of less than SD 250,000 ($135,000) from nonbank customers.

The remaining 87 banks operating in the domestic Singapore market hold "offshore" licenses. These banks operate primarily in the offshore "Asian dollar market" (ADM) and are permitted to undertake only limited Singapore dollar activities in order to strengthen financial linkages between Singapore and international banks abroad. In addition to the constraints imposed on restricted license banks, offshore license banks cannot accept any interest-bearing deposits from resident nonbank customers and are subject to an aggregate limit of SD 50 million ($27 million) total credit to resident nonbank customers.

In addition to the 137 commercial banks, 66 merchant banks operate in Singapore. They do not require MAS licenses, but must receive initial MAS permission to establish operations in Singapore. The bulk of their activities are related to securities. Merchant banks are allowed to accept deposits and raise funds only from banks and other financial institutions; however, their Asian Currency Units (which operate in the Asian Dollar Market) do not face the same restrictions and therefore accept foreign currency deposits from customers. Merchant banks raise over 80 percent of their funds from the interbank market, with the remainder coming from share capital and nonbank customers.

Other important players in Singapore's financial market are the 31 nonbank financial institutions (NBFI) and the Post Office Saving Bank. NBFIs can accept time and savings deposits, but cannot offer checking accounts. They can deal only in Singapore dollars and pay higher interest rates than banks. NBFIs specialize in housing, construction, consumer purchases, leasing and commercial receivables. The NBFIs have 136 branches. About half of the NBFIs, comprising two-thirds of the branches, are owned by local banks.

The GOS set up the Post Office Savings Bank (POSB) in 1972 to mobilize domestic savings for public sector investment. The POSB was modeled after the Japanese post office savings system and has been very successful. It had 138 branches and 313 ATMs at the end of 1989, with total deposits of SD 13.2 billion ($7 billion) in over 3.6 million accounts. In 1989, the POSB re-deposited 56 percent of its deposits to the banking system, where its placements accounted for 18 percent of total deposits. According to the MAS, 70 percent of POSB redeposits are placed with foreign banks, although more have ended up with U.S. institutions.

Table I

Financial Institutions Assets
(1986 - 89)
(SD Billions)

Institution	1986	1987	1988	1989
Commercial Banks	76.8	86.5	96.4	127.2
Asia Currency Units	437.3	490.0	547.0	629.4
Nonbank Financial Institutions	6.9	7.7	8.5	10.1
Merchant Banks	31.6	32.1	36.9	34.0
Total	552.6	616.3	688.8	820.7

Table II
Commercial Bank Market Share
(Percent)

	Local Banks	Foreign Banks (Full & Restricted)	Offshore Banks
Total Assets			
1970	41.1	58.9	N/A
1980	13.6	43.6	42.8
1985	10.2	32.6	57.2
1986	8.3	30.1	61.6
1987	8.4	28.5	63.1
1988	8.4	29.0	62.6
Deposits			
1970	40.8	59.2	N/A
1980	26.3	57.9	15.8
1985	24.9	47.9	27.2
1986	23.1	44.9	32.0
1987	24.3	44.2	31.5
1988	25.5	46.6	27.9
Loans and Advances			
1970	40.3	59.7	N/A
1980	20.9	46.6	32.5
1985	16.4	37.7	45.9
1986	15.1	33.9	51.0
1987	12.5	28.9	58.6
1988	11.8	26.6	61.6

Note: Table II includes both domestic and ACU Operations. The MAS does not make available more disaggregated data that distinguish between local and foreign bank market shares.

One hundred ninety-two of the banks described above have Asian Currency Units (ACU), which are a separate set of books for transactions in the Asian dollar market (ADM). The ADM is the Asian counterpart of the Eurodollar market in London, and includes all non-Singapore dollar business done in Singapore. In terms of asset size, the ADM dwarfs the domestic Singapore dollar market. At the end of 1989, total ADM assets were $337 billion, compared to SD 127 billion ($67 billion) in the domestic market.

The structure of the ADM is very close to the Eurodollar market. Transactions are largely interbank, although nonbank customers are also very important. A large foreign exchange market has developed to support and complement the ADM as Singapore has become a funding center for banks' regional and international activities. The MAS regulates and supervises the ADM, which is governed by Singapore's Banking Act. There have not been restrictions on transactions with Singapore residents since 1978, provided that no transactions are in Singapore dollars. The MAS notes that under Section 77 of the Banking Act, local banks' Singapore dollar and ACU operations are subject to lending and investment limits from which foreign banks' ACU operations are exempt. Unlike domestic banks, foreign banks are not required to maintain a certain level of general loan loss reserves.

U.S. Presence in the Market

U.S. financial institutions have a sizeable presence in Singapore's financial sector. Four U.S. banks have full licenses (Citibank, Chase Manhattan, Security Pacific, and Bank of America), one financial institution has a restricted license (American Express Bank), and 13 have offshore licenses. U.S. interests have at least 50 percent of the shares in 10 merchant banks, while four U.S. banks are among the 47 foreign banks that have representative offices in Singapore. The four fully licensed U.S. commercial banks have a total of nine branches and 11 ATMs. Each ATM is on the outside of the branch building. The restricted license bank, AMEX, would like to upgrade to a full license, but the GOS has not granted new full licenses in almost two decades. A number of other U.S. banks would also like to increase their activities in the Singapore dollar segment of the market, but are precluded because only offshore licenses are available to them.

The GOS does not disaggregate Singapore dollar-denominated assets from the total data it publishes on the banking industry in Singapore. The data in the table below are in Singapore dollar terms, for the end of 1988, and include the consolidated assets (i.e., including ACU assets) of U.S. banks in Singapore.

Table III
Assets[2] of U.S. and Other Banks in Singapore
Year-End 1988
(SD Billions)

Banks	Assets	Percent of Total
Total Commercial Banks & ACUs	643.4	100.0
All Banks' Singapore Dollar Assets	127.2	19.8
13 Singapore Banks	82.1	12.8
U.S. banks - full and restricted license	85.2	13.1
U.S. banks - offshore license	107.3	16.7
Total U.S. Bank Assets	192.5	29.8

Source: KPMG Peat Marwick, 1989 Survey of Financial Institutions in Singapore.

The local full license banks in 1988 had SD 525.7 million ($270.1 million) in profits, based on assets of SD 82.1 billion ($42.2 billion). The four U.S. full license banks earned SD 121.7 million ($62.5 million) on assets of SD 77.5 billion ($39.8 billion), the vast majority of which were in the much more competitive Asian dollar market. Thus, the local banks earned four times the average return on assets of the U.S. banks. Some caution is necessary in comparing these figures because of the U.S. banks' focus on the ADM; however, the local banks' much lower cost of funds from their branch and ATM networks is the major factor.

Table IV
Profitability Comparison
(SD Millions)
1988

Type	Profits	Assets	Percent Return on Assets
Local Banks	526	82,100	.64
U.S. Full License Banks	122	77,500	.16

Source: KPMG Peat Marwick, 1989 Survey of Financial Institutions in Singapore

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TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no known Singapore laws that distinguish between foreign and domestic companies in any industry or sector of the economy. The MAS plays a statutory regulatory role in supervising all financial and securities institutions, with its powers derived from the relevant legislation (e.g., the Banking Act). In practice, MAS policy denies national treatment to foreign companies in the banking industry. A list of these barriers follows.

-- The MAS has not approved a new full banking license since 1973. Some foreign banks operating in Singapore with restricted and offshore licenses would like to move to full license status but have run into the MAS's belief that Singapore is "overbanked." The GOS points out that it has not permitted any domestic full license banks to set up either, but in fact, the domestic market has consolidated around the "big four" Singapore banks during this period, and we are not aware of any local interests that want to set up a new full license bank. The big four control the other nine local banks, making it virtually impossible for either local or foreign interests to buy their way into the market through an acquisition.

-- Foreign equity ownership of local banks is limited to 40 percent, with individual (or related group) foreign investments limited to 5 percent of total shares.

- -- Only locally owned full license banks have been permitted to open new branches for quite a few years. The MAS defines automated teller machines (ATMs) as branches, so foreign banks may not have ATMs anywhere except on the wall of their existing premises.

- -- Foreign banks may not join the existing ATM network, in which all the local banks participate. Furthermore, the MAS prevents the foreign banks from setting up their own ATM network.

- -- The local banks have formed a company called "NETS" that has created a point of sale automatic debit and payment arrangement with local retailers that accept locally issued bankcards (e.g., Visa and Mastercard). Foreign bank issuers of bankcards are excluded from this officially sanctioned monopoly and are prevented from setting up a similar arrangement themselves.

- -- The MAS has on several occasions restricted foreign banks from introducing new technology to the Singapore market. Local banks, for example, were able to offer electronic telephone banking several years before foreign banks were allowed. Foreign banks are not permitted to offer banking from home by personal computer, while local banks are permitted to do so.

CONCLUSION

There are significant denials of national treatment in the domestic market and no improvement has been made. Foreign banks continue to hold a large share of the market and U.S. banks have a sizeable presence, but new entry by foreign banks and expansion of their operations is generally restricted. Fully licensed foreign banks have not been permitted to open new branches for several years. Depending on the type of license a foreign bank holds, it is subject to restrictions limiting its ability to compete for domestic banking business. Foreign banks have also been restricted in introducing new technology if local banks are not able to offer similar services. Singapore's offshore market, however, is significantly larger than the domestic market and foreign institutions are granted national treatment in this market.

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*U.S. dollar figures calculated at the following rates:
1988: $1 = SD 1.9462 YE
1989: $1 = SD 1.8944 YE
1990: $1 = SD 1.8540 (June 1, 1990)

AA = Annual Average
YE = Year-End

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[1] The asset data exclude financial institutions that are not members of the Federal Reserve and are net of intra bank claims.

[2] The data in Tables III and IV are based on gross assets, including balances due from head office/holding company and branches and contingent liabilities and commitments. The asset data given at the beginning of the chapter are based on Federal Reserve call reports, are net of intra bank claims, and do not include contingent liabilities and commitments.

22. Singapore - Securities

SUMMARY

Singapore is a small economy with a large financial sector. In 1989, gross national product was SD 56.3 billion ($28.9 billion),* with the financial sector accounting for over 28 percent. Banking -- especially the offshore Asian dollar market and foreign exchange trading that foreign institutions dominate -- accounts for the vast majority of the sector's activity. The Government of Singapore (GOS) has recognized the need to diversify beyond banking and has succeeded in expanding financial and commodity futures trading.

The Government's efforts to establish Singapore's securities industry as an important international market has produced modest results. Singapore's securities market is small and thin, reflecting, in part, the small size of the country's domestic economy. With recurring fiscal surpluses, the GOS does not need to finance deficits, and issues bonds and Treasury bills primarily to provide liquidity to the money market. Similarly, the small economy offers investors limited equity possibilities. The Government has sought to reverse this situation by privatizing the state sector, encouraging greater use of the stock exchange, creating an over-the-counter (OTC) market in regional shares and establishing links with the U.S. NASDAQ. Nevertheless, success has come slowly and the Stock Exchange of Singapore (SES) is still striving to attain a permanent place in a globalized financial system.

In the past, GOS policy kept foreign firms out of Singapore's equity market. Seats on the SES were reserved for domestic brokerage firms, which ran inefficient operations insulated by fixed-rate commissions set by the local brokerage cartel. However, the "Pan Electric" crisis in late 1985 exposed the local stock market's insufficient capital underpinnings, the need for transparency and greater professional services such as equity research. The three-day suspension of trading on the SES threatened Singapore's image and the Government's plans to expand the financial sector. Subsequently, the GOS decided to tap foreign firms in order to help modernize the securities industry.

Since 1987, nine foreign securities firms have received GOS permission to form joint ventures with domestic brokers. The entry of foreign firms has coincided with the internationalization of global equities trading, the introduction of advanced technology to the SES, and Japanese investor interest in high returns overseas. As a result, Singapore's position as a financial center has improved, but the split of the SES from the Kuala Lumpur stock market in late 1989 again fueled concerns about the ability of the SES to achieve and retain a position of international importance. The government has attempted to resist protectionist pressures in its efforts to develop Singapore's markets.

In October 1990, the Finance Minister announced that the SES would create a new membership category to allow foreign securities firms to trade on the SES. While this category has many restrictions, and some factors such as the price of the new seats were not yet decided, many observers viewed this move as an important, if limited, liberalization when it takes effect.

In general, foreign securities firms in Singapore have been interested in doing business on the SES directly but have feared that the GOS would open up the market only partially, not justifying further expansion of their Singapore operations.

Despite minor improvements, significant denials of national treatment exist.

OVERVIEW

Domestic Securities Markets

Merchant Banks: Singapore has 66 merchant banks, all but three of which are domestically incorporated. These banks conduct local securities business although, given the relatively small size of the domestic economy, most of their activities are focused offshore. Merchant banks engage in corporate finance, including underwriting equity shares and bonds, mergers and acquisitions, portfolio investment management and a variety of consultant and other fee-based activities. All but one of the merchant banks operate Asian Currency Units (ACUs, which are separate accounting units to deal in nonresident deposits) and maintain separate sets of books for their non-Singapore dollar offshore activities. Most of their assets consist of loans to banks (40 percent) and nonbank (34 percent) customers. Foreign exchange trading and other Treasury functions are also important activities. Although approximately three-fourths of merchant banking activities are offshore, domestic operations grew at roughly double the offshore rate during the 1980s.

The Monetary Authority of Singapore (MAS): The MAS regulates Singapore's entire financial system, including the merchant banks. The Domestic Banking Units of merchant banks (i.e., that section of the bank which lends Singapore dollars) are not permitted to accept Singapore dollar deposits or borrow from the public in any form. Nor can merchant banks raise funds by issuing CDs, commercial paper or promissory notes. They can raise funds only from other financial institutions and through share capital. In 1988, share capital and reserves constituted 43 percent of their total Singapore dollar liabilities. Despite the constraints, however, only two of the 67 merchant banks which existed in 1988 were Singapore-owned.

Merchant Banking
1985-88
(SD billions)

Measure	1985	1986	1987	1988	1989
Total Assets	28.21	31.58	32.12	36.92	34.70
Singapore Dollar Assets	4.87	5.47	7.16	8.27	7.63
Offshore Assets	23.34	26.11	24.96	28.65	27.07

Singapore Government Securities: With large recurring budget surpluses, the GOS does not issue securities to finance expenditures. Rather, the GOS issues debt instruments to regulate liquidity in the money market and to provide financial institutions with investment instruments to help them meet reserve requirements. Before 1987, there was a captive primary market (i.e., one in which banks were required to hold a specific percent of their deposits in government paper) but a dormant secondary market. As part of its efforts to develop the financial sector, the GOS restructured its debt market in 1987 to make it more active and liquid, and interest rates more market-related. It abolished government-set interest rates and shifted to a weekly auction system modeled after the U.S. Treasury auctions.

The GOS presently issues its debt (bonds with maturities of two to five years, and Treasury bills of three, six, nine, or 12 months maturity) to the public through primary dealers at market-determined rates. There are eight primary dealers which act as market makers and provide two-way quotes. Three of the eight primary dealers are foreign institutions; one (Citibank) is a U.S.-owned institution. There do not appear to be national treatment problems in Singapore's government securities industry.

After a sharp boost following the GOS' debt market restructuring in 1987, activity in the Singapore Government Securities Market (SGSM) slowed. Rising interest rates in Singapore since the second quarter of 1989 pushed up rates for alternative instruments. The average daily turnover on the SGSM increased from SD 9 million ($4.3 million) in 1987 to SD 440 million ($218.6 million) in 1988, while the daily volume of repurchase agreements rose from SD 100 million ($47.5 million) in 1987 to SD 850 million ($422.4 million) in 1988. In 1989, however, the average daily volume declined to SD 250 million ($128.2 million). The amount of GOS securities outstanding at the end of 1989 was only SD 7.53 billion ($4.0 billion), not including the Central Provident Fund (Singapore's social security system) which has held about 80 percent of GOS paper since the 1987 restructuring.

GOS Securities Operations
(SD billions)

Item	1985	1986	1987	1988	1989
Net GOS Fund Raising	4.61	1.21	3.85	4.04	4.94
Outstanding GOS Paper (Year-end)*	18.10	17.80	34.02	33.20	34.90
New Issues of GOS Securities	0.0	0.0	1.68	9.70	9.40

*Including book-entry government debt issued to the Central Provident Fund, which is not traded.

Stock Exchange of Singapore: Equities trading began in Singapore in 1938 with the predecessor of the current Stock Exchange of Singapore (SES). During the colonial era and the early independence years, Singapore and Kuala Lumpur had a joint stock exchange. They legally separated in 1973 when the parity ended between the Singapore and Malaysian currencies. However, the Singapore and Kuala Lumpur exchanges remained linked until the end of 1989, when the Malaysian Government ended the practice of dual listing of shares on each exchange. The SES currently lists the shares of 157 Singapore companies, which have a total market capitalization of almost SD 90 billion ($48.5 billion). The SES is owned jointly by its 25 member firms. At the end of 1988, these 25 firms had combined capital of SD 326 million ($167.5 million).

Until the mid-1980s, when the volume of international trading began to surge and many countries started to dismantle barriers to capital flows for portfolio investment, the Singapore and Kuala Lumpur exchanges played a minor role in the international equities market. Prior to the mid-1980s, the SES was a relatively restrictive, small exchange, characterized by low trading activity, labor-intensive and inefficient operations and minimal professional brokerage services. Securities firms were undercapitalized, indirectly subsidized by the lack of competition and fixed commission rates, and provided almost no research and analysis.

The problems on the SES came to a head in late 1985 following the Pan Electric crisis. Pan Electric Industries (Pan El) experienced financial difficulties which put considerable strain on the SES, threatening the solvency of several brokerages and tarnishing the image of Singapore's equities market. Firms had already overtraded for their own accounts and overfinanced customers' margin buying, weakening their positions prior to the downturn following Pan El's problems. Several brokerage firms were faced with defaults from uncovered forward contracts and extensive use of credit lines from local banks. As a result, the GOS intervened to close the exchange for three days and arrange a guaranteed "life boat" line of credit from the four big local banks. It also encouraged banks to delay calling loans until the situation stabilized. Nevertheless, the All Share Index fell 8.7 percent on the day trading reopened, and lost 20 percent for the year.

In an effort to strengthen the SES, the GOS increased the capital bases of brokerage firms, accelerated the pace of internationalization, improved the standards of business practices and increased competition. One of the most important changes occurred in February 1987, when the GOS allowed foreign shareholdings of up to 49 percent in SES member companies, and stated its intention to permit this percentage to rise to 70 percent within three years. The specific goal of encouraging foreign entry was to provide capital for ailing local firms. By early 1989, the GOS had approved nine such joint ventures and in October 1990, it announced that foreigners could increase their equity from the 49 percent limit to 70 percent in these nine joint ventures. Foreign participation in new joint ventures, however, is still limited to 49 percent. In addition, in October 1990, the Finance Minister announced that the SEC would create a new category of international members. An international member can be wholly owned by a foreign securities house and will be allowed to trade on behalf of nonresidents in transactions of any size on the SES, SESDAQ, and CLOB. They will also be permitted to deal on behalf of Singapore residents for transactions of not less than SD 5.0 million in any of the three markets. The SES has not yet decided what it will charge for these new seats. Many observers view this announcement as an important, if limited, liberalization.

In other efforts to attract foreign investors, the SES reduced commission rates from a 1 percent flat rate to a graduated range from 1 percent down to 0.5 percent on trades over SD 1 million ($528,000). The SES has also invested heavily in technology, and since early 1989 has operated on a floorless, fully automated basis via a computer network that matches buy and sell orders. The SES also has plans to move to a new system in the near future, whereby all share certificates will be held in a central depository.

By 1989, the SES had overcome problems exposed by the Pan Electric crisis. Trading volumes increased impressively in the latter half of the 1980s. The opening to foreigners was accompanied by the injection of foreign capital, and the equities market was buoyed by tremendous growth in offshore banking and foreign exchange trading. Although Singapore remained a small market, it increased in visibility and importance with the globalization of international equities trading, and benefitted from Japanese investor interest in foreign markets as the yen appreciated. GOS officials believe that the presence of additional foreign fund management activities would enhance the international position of the Singapore market.

SES Activities
1985 - 1989
(SD Billions, unless noted)

Measure	1985	1986	1987	1988	1989
Market Capitalization	71.50	86.30	86.20	105.40	136.30
Turnover by Value	6.32	8.00	22.50	12.81	39.15
New Funds Raised	0.05	0.94	1.35	0.94	0.89
Billions of Shares Traded	3.02	3.95	9.80	7.15	21.65
No. of Companies Listed	316	317	319	326	333

In late 1989, the Malaysian Government announced that it would de-link the Singapore and Kuala Lumpur (KL) exchanges by preventing Malaysian companies from listing their shares on the SES. In response to the loss of 55 percent of its shares and 45 percent of its capitalization, the SES set up an over-the-counter market called "CLOB International" for trading the shares in 134 Malaysian and six Hong Kong companies.

Despite a fast start, CLOB, which began in January 1990, has slowed considerably, in part due to back office settlement problems on the KL exchange and their effect on the issuance of share certificates. If these problems are resolved and activity revives, many observers believe that the market will be successful and could potentially be integrated into a 24-hour globalized trading system. The GOS has already discussed listing Indonesian companies on CLOB with the Indonesian Government.

Stock Exchange of Singapore Dealing and Automated Quotation System (SESDAQ): SESDAQ is Singapore's second stock exchange. The GOS launched SESDAQ in February 1987 to enable smaller, newer firms to raise long-term capital for business expansion. It currently lists 14 Singapore companies, which had a market capitalization of SD 811 million ($437.4 million) as of March 1, 1990. Modeled after the U.S. NASDAQ market for stocks, SESDAQ lists smaller companies the market views as having higher risk but good growth potential. Reflecting the greater perceived risk -- as well as its small size and lower liquidity -- the P/E multiple is 13 on SESDAQ compared to about 20 on the SES main board.

SESDAQ was the world's first "scripless" equity market, in which investors must open an account with the Centralized Depository System (CDS) eliminating the physical delivery of share certificates. CDS holds the scrip in its central depository, while settlement is effected by book entries between the buyer's and seller's accounts.

Within a month after SESDAQ was established in 1987, it entered into a three-year agreement with the U.S. NASDAQ for a joint listing of 35 NASDAQ stocks in Singapore. Despite this attempt to globalize trading, the number of NASDAQ shares traded on SESDAQ has fallen to 28. Trading is thin and on many days no NASDAQ trades occur. NASDAQ shares listed on SESDAQ are all blue chips (e.g., Apple Computer, Intel and Seagate Technology) but their prices are relatively high in a market where most shares average about $2-$5. Even with a standard block size of 100 shares, compared to 1,000 unit blocks for local shares, local NASDAQ listings encounter a stiff psychological resistance. Nevertheless, both exchanges intend to maintain and expand the SESDAQ-NASDAQ link by increasing the number of NASDAQ shares listed on SESDAQ.

It is possible that SESDAQ may be threatened as an independent trading board for two reasons. Since the SES/KL split, there is considerable pressure on the main SES to increase its number of listings. As a result, several of the larger companies listed on SESDAQ plan to move to the SES. Further, with the creation of CLOB International, it is probable that CLOB and SESDAQ will merge in the future. Many observers believe that a CLOB SESDAQ merger would be logical and the combined market would be a better fit for NASDAQ.

SESDAQ Statistics
1987 - 1989

Measure	1987	1988	1989
Listings (Year-end)	7	13	4
Average Daily Turnover (00's)	457	614	927
Market Capitalization (Year-end, SD millions)	235	373	811

U.S. Presence in the Market

The GOS has allowed nine foreign firms to establish in Singapore as joint ventures, although prior to October 1990, none of the firms had more than a 49 percent share. The GOS has insisted that the foreign firms not enter into joint ventures with the strong local firms, but buy into local brokerages that had problems in the mid-1980s. (Although, reportedly, two strong domestic firms would also be discouraged from merging.) Only one of the nine foreign firms involved in a joint venture is a U.S. firm, Bankers Trust. Bankers Trust's joint venture was primarily a capital infusion which was designed to help build a large Asia brokerage network and establish a presence in Asia's dynamic markets. Nine other U.S. securities firms also have offices in Singapore -- Merrill Lynch, Shearson Lehman Hutton, Prudential-Bache, Goldman Sachs, Citicorp Vikers, J.P. Morgan, Security Pacific, Hoare Govett, Smith Barney and Salomon Brothers. They are established both as dealers and representative offices, perform equity and regional economic research, and pass on trades of SES local stocks to local brokers. Foreign securities firms are relegated to these activities primarily because they are prohibited from owning a seat on the stock exchange (unless, as noted above, they establish a joint venture with a weak local firm). Many also have dealers licenses that enable them to deal in securities of non-SES listed companies.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The GOS creation of CLOB International has given it options to respond to the demands of the foreign brokering community that it is currently evaluating. Prior to the October 1990 announcement, the GOS had been overdue in adhering to its previous commitment to expand the permissible equity held by foreign securities firms in SES member firms. The GOS has faced pressure from foreign brokers to liberalize. The local brokerage community, however, has feared direct competition from the large U.S., U.K., and Japanese firms and has opposed the foreign capital the GOS would like to attract to the Singapore equity market. Some foreign securities firms have insisted on full ownership, i.e., 100 percent equity, in any venture which seeks capital infusion.

In the past, observers had speculated that there were two options the GOS might be considering to increase foreign participation. The first was to allow up to 100 percent foreign ownership of seats on the SES but possibly restricting those members to trading only in the OTC market. (Thus, if these firms were to trade a main board stock, they would have to use an existing broker.) The second was for the SES to allow 100 percent foreign-owned seats but possibly price them so high that only the largest foreign firms, such as the big Japanese houses, would be able to justify the expense. The October 1990 liberalization could address some of these concerns. Regardless, the GOS's desire to earn a permanent place in the global equities market means that it will have to override narrow local interests and eventually open its securities market if it is to achieve its objectives.

CONCLUSION

Despite some noteworthy improvements, important denials of national treatment still exist. As a matter of policy, Singapore has in the past strictly limited the activities of foreign firms in its securities market. The government, however, has recently pursued measures to make Singapore a major international market and has thus recognized the need to tap the expertise of foreign firms. Since 1987, nine foreign securities firms received permission to form joint ventures with local brokerages with equity limited to 49 percent. In October 1990, the government announced it would allow foreign securities firms to increase their ownership to 70 percent in these nine joint ventures. When implemented, this will be a modest step forward. The foreign share of new joint ventures, however, will still be limited to 49 percent.

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*U.S. dollar figures calculated at the following rates:

1987: $1 = SD 2.1060 AA
1988: $1 = SD 2.0124 AA; 1.9462 YE
1989: $1 = SD 1.9503 AA; 1.8944 YE
1990: $1 = SD 1.8540 (June 1, 1990)

AA = Annual Average
YE = Year-End

23. Taiwan - Banking

SUMMARY

Taiwan has an extensive financial system basically controlled by the authorities. There are 24 domestic banks operating 977 offices and 33 foreign banks operating 38 offices. At year-end 1989, 12 U.S. banks operated a total of 15 branches in the profitable Taiwan market.

Since July 1987, Taiwan has taken significant steps to deregulate the financial sector. Of particular importance in banking was implementation of a revised Banking Law in April 1990. The new law deregulated interest rates, permitted the establishment of new private banks, and expanded the scope of business for foreign banks to include savings and trust activities. The law also established branches outside Taipei and Kaohsiung, subject to approval of the Ministry of Finance that market conditions warrant additional banking offices. Until now, foreign banks have been permitted only two offices - one in each of the two cities. Even if this provision is implemented liberally, foreign banks will face restrictions, most notably that their activities are limited by Taiwan's regulatory practice of defining a foreign bank's capital in terms of its Taiwan branch(es) rather than its global worth. While not a denial of national treatment, this practice limits operations through rules linked to capitalization, such as limits on accepting New Taiwan dollar deposits, making loans to one borrower, and guaranteeing commercial paper. Moreover, this practice will likely prevent Taipei from becoming a major international financial center.

The Department of the Treasury has addressed these problems in ongoing discussions with Taiwan's authorities, under the auspices of the American Institute on Taiwan. While there has been some improvement, important denials of national treatment continue.

At year-end 1989, 12 U.S. banks in Taiwan operated 15 branches with assets of $3.9 billion and five subsidiaries with assets of $295 million. This presence is roughly comparable, in terms of assets, to the U.S. bank presence at year-end 1985. At that time, 14 U.S. banks in Taiwan operated one branch each, with total assets of approximately $3.8 billion. U.S. banks had five representative offices in Taiwan. Six U.S. banks were affiliated with seven finance or investment companies in Taiwan.

At the end of 1989, three Taiwan banks in the United States operated one agency with assets of $2.1 billion, four branches with assets of $407 million, and one subsidiary with assets of $546 million. Taiwan banks maintain three representative offices in the United States. This presence represents an increase of two operating offices and $180 million in assets since March 31, 1986. At that time, one Taiwan bank operated two branches, a subsidiary, a representative office, and an agency in the United States, with total assets of $2.3 billion. Another Taiwan bank maintained two representative offices in the United States. In addition, as of year-end 1985, Taiwan individuals or entities reported majority ownership of four banks in the United States. These banks had seven branches and total assets of $628 million.

OVERVIEW

Domestic Banking Market

Taiwan has a very extensive financial system, covering banks, credit cooperatives, investment trust companies, the postal savings system, insurance companies, bills/securities financing companies and offshore banking units. At the end of 1989, there were 4,271 banking offices in Taiwan. Banking density was one office per 4,683 people on the island, a level comparable to that in most developed nations. In 1989, the entire financial system registered total assets of NT$ 10.922 trillion ($414.2 billion),* of which 20 percent were held by the Central Bank and 49 percent by commercial banks.

Taiwan's financial system has always been under the tight control of the Taiwan authorities. Public agencies exert total or partial control over 2,468 banking offices, accounting for 68 percent of the assets. The Taiwan authorities control 83 percent of the number of banks (excluding the Central Bank but including commercial banks and medium business banks). In terms of assets, the authorities accounted for 100 percent of the postal savings system and bills/securities financing companies, 10 percent of insurance companies, and 12 percent of investment trust companies. Although credit cooperatives and credit departments of the Farmers' and Fishermen's Association are private, they are heavily influenced by the authorities.

Taiwan's Financial System
December 31, 1989

Institution	Number Head Offices	Branch Offices	Assets ($M)
Central Bank	1	0	83,991
Domestic Banks	16	692	172,834
Foreign Bank Branches	33	5	9,278
U.S.	(12)	(2)	(3,915)
Others	(21)	(3)	(5,363)
Medium Business Banks	8	261	22,260
Credit Cooperative Associations	74	358	27,961
Credit Dept. of Farmers' and Fishermen's Association	307	685	20,528
Investment/Trust Companies	8	44	10,260
Postal Savings System	1	1,574	36,357
Life Insurance Companies	11	59	10,913
Non-Life Insurance Companies	19	73	1,157
Bills Finance Companies	3	15	1,158
FuhHwa Securities Company	1	0	782
Offshore Banking Unit	23	0	16,685
Total	505	3,766	414,164

Although in recent years a rising number of enterprises have raised capital by issuing stocks, only 181 of 350 eligible companies are listed on the Taiwan Stock Exchange. By and large, companies prefer to raise funds through bank loans rather than by issuing capital. At the end of 1989, outstanding bank loans totalled NT$ 4.051 trillion ($154.8 billion), 9.3 times the NT$ 437 billion ($16.7 billion) total stock capitalization of the listed companies.

U.S. Presence in the Market

The U.S. presence in Taiwan's financial market is minimal. Assets of U.S. financial institutions (including banks and insurance companies) totalled NT$ 144 billion ($5.5 billion) at the end of 1989, accounting for 1.3 percent of the aggregate assets of the entire financial system. At year-end 1989, there were 12 U.S. banks with 15 branches in Taiwan. The banks' total assets were only $3.8 billion, about 2 percent of the total assets in the banking system. There were six U.S. offshore banking units which represent 26 percent of the assets of Taiwan's offshore banking sector. There is no U.S. presence at all in such fields as credit cooperatives, the postal savings system and bills/securities finance companies.

There is only one U.S. investment trust company in Taiwan. Foreign ownership of investment trust companies is limited to 40 percent.

In the past three years, Taiwan has implemented a number of measures to liberalize the financial system. In July 1987, the Central Bank lifted most restrictions on capital movements. Prior approval of the Central Bank is no longer required for current account foreign exchange transactions. For capital accounts, prior approval is no longer required for outward remittances under $5 million and inward remittances under $2 million per account per year. (The annual inward/outward remittance limits apply to an entity, whether an individual or legal entity, not to an account.) Effective January 1, 1988, a ban on the establishment of new securities firms was removed.

The Banking Law was revised in July 1989, and implementation guidelines were promulgated in April 1990. The Law deregulated interest rates, permitted the establishment of new private banks, and expanded the scope of business for foreign banks. Foreign banks are now allowed to offer additional services including: accepting savings deposits; providing medium and long-term loans; accepting, managing and employing trust funds without guarantee of profit; and providing securities brokerage and underwriting services subject to Taiwan Securities and Exchange Commission (SEC) approval.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Despite recent improvements, U.S. banks do not receive national treatment in Taiwan. Generally, Taiwan only accepts a foreign bank's application to establish a branch if the bank has had a representative office in Taiwan for at least one year, conducted a certain amount of business ($1 billion) with Taiwan, and ranks among the world's 500 largest banks in terms of assets or capital. Taiwan also accepts foreign banks which have had a physical presence in Taiwan for more than 10 years and meet certain business volume requirements ($1 billion) in the latest three years. This is an improvement over the previous practice of only accepting applications from the world's 150 largest banks. Three foreign bank applications to establish a branch are approved per year, an increase of one over the previous practice.

Another major denial of national treatment, however, is the restriction limiting foreign banks to two branches, one in Taipei and one in Kaohsiung. This limitation takes on added significance because Taiwan's regulatory authorities define foreign bank capital as branch capital for most significant purposes.

Under April 1990 guidelines for foreign banks, the Ministry of Finance (MOF) announced that subject to MOF approval, foreign banks would be allowed to establish additional branches anywhere in Taiwan that market conditions warrant the establishment of a branch. Although not transparent, this new policy will be a welcome improvement if it has the effect of allowing foreign banks to branch when and where they choose.

While not a denial of national treatment, the branch capital accounting approach limits foreign banks' operations to an extent that makes it difficult for them to compete with domestic banks which have extensive branch networks. Foreign banks are only allowed to accept New Taiwan dollar deposits of 15 times their paid-in capital, excluding retained earnings. They can import capital, but they are not allowed to raise capital locally by issuing bonds. Domestic banks are not subject to a limit on deposits and may issue bonds to raise capital.

The branch capital approach also limits the size of loans and guarantees that foreign banks can extend. Specifically, loans to one borrower are limited to the greater of NT$ 500 million ($18.2 million) or 10 percent of the foreign branch's total New Taiwan dollar exposure. (Foreign banks are allowed to extend foreign currency loans of up to 25 percent of each bank's global net worth.) Local banks, however, are allowed to lend a single borrower any combination of New Taiwan dollar and foreign currency loans of up to 25 percent of their institutional net worth if the loan is secured and 5 percent if it is unsecured. Foreign branches can guarantee commercial paper only up to ten times their net worth, while local banks do not face such a restriction.

The July 1989 amendments to the Banking Law allow foreign banks to offer long-term (more than seven year) loans, which had previously been the exclusive purview of savings banks. The branch capital approach creates a problem for foreign banks in the long-term loan business because Article 84 of the Banking Law limits residential construction loan exposure to 20 percent of savings deposits. Foreign banks' deposits are limited by their paid-in capital, with the result that residential construction loans will be proportionally restricted.

Foreign banks also face discriminatory treatment in their foreign exchange operations. While all domestic and foreign banks face a $6 million limit on their U.S. dollar oversold (short) position, the five largest domestic banks have a higher limit on their overbought (long) position than other domestic banks and all foreign banks. The five largest domestic banks' overbought limit is $50 million, while the other banks' limit is $20 million. This ceiling is particularly onerous for foreign banks because they are more active than domestic banks in the foreign exchange market and they have to hedge their foreign funded capital.

As of August 1, 1990, foreign banks were permitted to borrow and lend foreign currency in Taiwan's call market. Previously, only 50 Taiwan foreign exchange banks were allowed to participate in this market.

Banks and financial institutions issuing foreign and local credit cards are required to join the National Credit Card Center (NCCC), a quasi-official organization empowered to "regulate" the credit card industry. Regardless of an issuer's own processing capability, the compulsory NCCC membership requires card issuers to have the NCCC handle all their card production, first level authorizations, and sales draft processing. The processing costs charged by the processor are passed on the issuers, who cannot control the costs allocated to them. Overlapping interest between the NCCC Board and the processor discourages the NCCC from giving issuers permission to self-process and/or from negotiating for more reasonable fees with the third party processor. The NCCC monopoly weighs particularly heavy on U.S. banks, which have substantial experience and capability processing credit cards.

Domestic Securities Market

The three finance corporations -- Chung Hsing, Chung Hua and International -- are the only authorized dealers, underwriters and brokers in the primary and secondary money markets in Taiwan. These corporations are majority-owned by Taiwan's large state banks. Neither domestic banks nor foreign banks in Taiwan are permitted to deal directly in short-term money market instruments, nor are they permitted to offer interest rate swaps. They may offer currency swaps with other banks, but not with corporate customers. With regard to insurance, most of Taiwan's domestic banks are licensed to broker property insurance, although they cannot broker life insurance. Foreign banks are not specifically prohibited from brokering property insurance, but no foreign bank has applied.

FINANCIAL MARKET DISCUSSIONS

Since Spring 1988, the Treasury Department has held a number of discussions with Taiwan's authorities, under the auspices of the American Institute in Taiwan. During the course of these talks, Taiwan indicated that it will resolve a number of specific concerns to U.S. financial institutions through the implementation of the amended Banking Law in April 1990. The stated liberalizations include the same ability as local banks to conduct savings and trust activities as well as more transparent and broad criteria for establishing an initial foreign bank branch. With the exception of upgrading one U.S. bank's representative office to a branch office, these liberalizations have not brought any practical results more than a year after they were legislated. In addition, Taiwan has committed to lifting its onerous restrictions on additional foreign bank branches, but has yet to issue additional licenses. These issues and others must be resolved if foreign financial firms are to receive national treatment in Taiwan.

CONCLUSION

While there has been some improvement, important denials of national treatment continue. On the whole, foreign banks are still denied national treatment in Taiwan. A number of steps have been taken since 1987, however, to liberalize the banking system and expand foreign banks' ability to compete on an equal footing with domestic banks. Given the recent announcement of these liberalizations, it remains to be seen if they will result in actual progress. With the implementation of the revised Banking Law in April 1990, foreign banks are to be permitted to engage in saving and trust activities. Some restrictions have also been relaxed on the entry of new foreign banks, the establishment of additional bank branches and foreign banks' ability to accept local currency deposits. Nevertheless, discrimination against foreign banks still remains in some of these areas, particularly regarding their ability to fund themselves competitively in local currency, the limitations on branching, and the inability to establish subsidiaries. Despite discriminatory treatment the Taiwan market has been profitable for U.S. banks.

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*U.S. dollar figures calculated at the following rates:

1989: $1 = NT$ 26.37 AA; 26.17 YE
1990: $1 = NT$ 27.46 (end-May 1990)

AA = Annual Average
YE = Year-End

24. Taiwan - Securities

SUMMARY

Taiwan's securities market has grown rapidly in the past four years, but the market is still small. For example, despite increased activity, the Taiwan Stock Exchange (TAIEX) had only 185 listed companies and 198 issues as of end-April 1990. However, turnover has been high, contributing to a high price/earnings ratio of approximately 70 as of June 30, 1990. Financial futures, warrants and options do not exist. Bond issues in general are insignificant, with corporate bonds negligible. U.S. presence is minimal. Taiwan does not permit the listing of U.S. or other foreign securities on the TAIEX. It does not allow foreigners to purchase Taiwan securities directly, nor does it allow foreign credit raters or underwriters to operate in Taiwan. Foreign ownership is limited in integrated securities firms and securities investment trust companies. There is no limit on foreign ownership in securities investment consulting enterprises. Overall, U.S. ownership in the securities industry is very small and national treatment is not provided.

U.S. companies, the local subsidiaries and most joint ventures of U.S. companies cannot list on the Taiwan Stock Exchange. U.S. brokerage houses may not set up subsidiary operations in Taiwan, nor enter into joint venture arrangements. They cannot offer securities financing services. Under very strict qualification requirements, Taiwan securities authorities approved the applications of two foreign brokerage houses to establish branch offices in Taiwan in February 1990. Taiwan plans to open the stock exchange to a limited number of foreign institutional investors about the end of 1990. The authorities have not provided a timetable for further market openings. Indirect foreign investment in the Taiwan stock market is allowed through four Taiwan funds listed on the New York and London exchanges. Local investors can purchase U.S. or other foreign securities through the trust/investment companies, banks or via offshore agents and brokers, but such transactions must be executed offshore.

In 1983, Taiwan set up a three-stage plan to liberalize the local securities market, with the ultimate goal of direct participation by foreign investors without restrictions. There has been modest progress. Despite the lack of a timetable for the plan, growing demand from market participants and policy talks with U.S. officials may force the authorities to expedite the pace of liberalization.

During bilateral talks with the Taiwan authorities, the Treasury Department has emphasized the importance of equality of competitive opportunity in the local securities market. While there has been minor improvement, significant denials of national treatment continue.

OVERVIEW

Domestic Securities Markets

Taiwan's securities market is small in terms of market size and the number of available products. The total par value of stocks listed on the TAIEX was NT$442 billion ($16.7 billion)* at the end of April 1990. As of April 1990, there were 198 stocks listed on the Taiwan Stock Exchange compared with about 3,100 issues of bonds and 1,681 issues of stock listed on the New York Stock Exchange (NYSE). At that time, bonds accounted for 3.2 percent, or NT$201 billion ($7.6 billion) of the market value of the TAIEX and stocks accounted for 96.8 percent, or NT$6,033 billion ($228.6 billion) of that market value.

Despite its small size, the TAIEX expanded rapidly between 1986 and 1989. Two important factors contributed to this development. First, the sharp rise in foreign exchange reserves fostered excessive liquidity in a market with limited investment opportunities. Second, a January 1988 revision of the Securities Transaction Law lifted a ten-year ban on the establishment of new securities firms. Between 1988 and 1989, the number of brokerage houses increased from 28 to 247; traders from 10 to 32; and underwriters from 23 to 45. The listed issues of stocks increased 39.2 percent from 130 to 181 during the period 1986 - 1989.

These developments contributed to a 10.5 fold jump in the TAIEX index from 840 points at the beginning of 1986 to 9,624 points at the end of 1989, and 9,292 points as of end-April 1990. The massive capital outflow - - estimated to be NT$197.9 billion ($7.5 billion) in the first five months of 1990 - - caused a dramatic decline in the local stock market. In the second quarter of 1990, the TAIEX fell reaching 5,522 points on June 20, 1990, 56.5 percent below its peak of 12,680 points set on February 12, 1990.

In recent years, the TAIEX could be characterized by three features: speculation; high turnover; and few products, including only minimal bond issuance. Local investors, awash in disposable income and seeking investment opportunities, have been particularly attracted to the stock market. With a population of twenty million, Taiwan has about 4.4 million brokerage accounts and approximately 2 million active stock investors. Consequently, the market has moved upward despite wide swings in the TAIEX index. For example, during a recent twelve month period, the index experienced three losses of approximately 1,000 points.

Trading volume also has been exceptionally high compared to major markets. In April 1990, for example, average monthly trading volume totalled 17 billion shares on the TAIEX, higher than the NYSE's 2.8 billion shares and the Tokyo Stock Exchange's 11.3 billion shares.

Financial products on the TAIEX are few and not well developed. The bond market is relatively small compared to its counterparts in major global markets. Bonds accounted for less than 1 percent of total market turnover in 1989. On the stock market, as of end-1989, 175 out of the 181 equity issues were common stocks and six were preferred; the market capitalization of these 181 issues was NT$6,174 billion ($235.9 billion). There were 13 mutual funds (five closed-end funds listed on the TAIEX and eight open-end funds not listed on the TAIEX) as well as four Taiwan funds listed on offshore stock exchanges.

Taiwan's bond market as a whole, which totalled NT$350 billion ($13.4 billion) outstanding at year-end 1989 is dominated by public issues, which accounted for NT$340 billion ($13.0 billion). The provincial and municipal bond markets, whose total bonds outstanding amounted to less than NT$40 billion ($1.5 billion) at year-end 1989 were small because local entities rely on central authorities for revenue. Taiwan's corporate bond market has had two types of instruments, private and public enterprise bonds. This market has been relatively inactive since most public and private corporations have turned to Taiwan's stock market to raise capital. Only three private companies issued bonds in 1989 totalling NT$10 billion ($379.2 million), or 3.5 percent of the total bond market. Convertible bonds are relatively new in Taiwan.

Foreigners can invest in Taiwan's securities market only indirectly. The TAIEX has no warrants. Financial futures and options are prohibited.

U.S. Presence in the Market

Although the ban on the establishment of new securities firms was lifted on January 1, 1988, foreign ownership in local brokerage houses, trading firms and underwriting companies is still not permitted. Up to 40 percent foreign ownership is allowed in an integrated securities company - - a firm licensed to operate a comprehensive range of brokerage, trading and underwriting functions. Of the 23 integrated securities firms, only two have minor U.S. ownership. In January 1989, the Taiwan Securities and Exchange Commission approved two U.S. brokerage firms' applications to open branch offices in Taiwan, but neither has yet established a local office. Securities financing is monopolized by the state-owned Fuh-hwa Securities Finance Co., LTD. Only Fuh-hwa can legally finance the purchase of securities by investors. This financing is essentially loans for margin purchases of stocks. Neither U.S. nor local private firms have any presence in this segment of the market.

The TAIEX is basically a closed market and the U.S. presence is virtually nonexistent. U.S. securities (including bonds, stocks and other products) are not allowed to be listed on the TAIEX. Individual and institutional investors from the U.S. are not allowed to buy or own Taiwan securities, although they can invest indirectly through four mutual funds listed overseas: two on the NYSE and two on the London Stock Exchange. As of the end of August 1990, the capitalization of the four offshore funds was $375 million, which accounted for about 0.4 percent of the total market capitalization of all the listed companies in Taiwan.

Foreign participation on the TAIEX is almost completely forbidden: foreigners who do not have "resident" status (a resident foreigner is defined as a foreigner holding both a residence certificate and a work permit) cannot buy/sell domestic stocks nor can foreign companies list their stocks in Taiwan. Since March 1990 foreigners holding both resident and work permits have been able to buy/sell mutual funds, public bonds, corporate bonds and financial debentures. They still, however, cannot buy/sell domestic stocks. Foreign companies also may not list their stocks in Taiwan.

U.S. presence in Taiwan's securities markets is limited primarily to such institutions as securities investment trust companies (SITC) and securities investment consulting enterprises (SICE). Out of the four SITCs which manage twelve mutual funds - - four offshore and eight at home - - three SITCs involve U.S. securities firms, but the U.S. ownership is very small. The 56 SICEs are permitted to provide advice only on foreign securities and promote foreign mutual funds for investors intending to transact their business offshore. No other activity is permissible.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Taiwan does not grant U.S. financial firms national treatment. Generally, foreign financial firms may not set up subsidiary brokerage operations in Taiwan, nor enter into joint venture arrangements. In June 1989, the Taiwan authorities announced that three foreign brokerage houses would be permitted to establish branch offices. However, the qualification requirements were very strict: NT$2 billion ($75.8 million) in capitalization and NT$20 billion ($758.4 million) in total assets. By the October 31, 1989 deadline, two U.S. firms had applied. Their applications were formally approved in February 1990. No office, however, has been established. The authorities do not have a timetable for further market openings.

U.S. financial firms are also banned from serving as traders or underwriters. Like their local counterparts in the private sector, the U.S. firms may not operate securities financing businesses, a service reserved exclusively for the state-owned Fuh-hwa Securities Finance Co. U.S. companies may, however, enter into a joint venture agreement to set up integrated securities firms, designed to operate all of the brokerage, trading and underwriting functions. But their investments in such companies are subject to a 10/40 rule: no one foreign company can own more than 10 percent and combined foreign ownership must not exceed 40 percent. Furthermore, a U.S. company can invest in only one local integrated securities firm. Local banks are allowed to operate brokerage houses, trading companies and/or underwriting firms. Since April 12, 1990, when the amended Guidelines for the Establishment of Branches and Representative Offices of Foreign Banks became effective, branches of U.S. banks have been accorded the same privileges. Practically, U.S. banks will not be able to operate securities business in Taiwan unless the Taiwan authorities allow U.S. banks to establish wholly owned subsidiaries in Taiwan.

Foreign ownership is permitted in the securities investment trust companies (SITCs), but foreign ownership may not exceed 49 percent. There is no ban or quota on the establishment of securities investment consulting enterprises (SICEs), and there is no limit on foreign ownership. However, the SICEs are allowed to provide only information and advice on "permitted" foreign securities (including bonds, stocks and mutual funds). Transactions must be conducted offshore primarily through local banks. Foreign mutual funds introduced by SICEs have to meet strict qualifying criteria: they must have been in place for at least two years, their management companies must have been in place also for at least two years and total assets under management must be over $1 billion.

In addition, U.S. stocks, bonds, mutual funds and other financial products cannot be listed on the TAIEX. Neither can the local subsidiaries of U.S. companies, even if the subsidiaries are wholly U.S.-owned. Joint ventures may be listed on the TAIEX, but special permission must be obtained beforehand from the Foreign Investment Commission. In such a case, foreign investors may hold and sell shares but may not buy any other shares on the TAIEX. Effective October 1989, U.S. insurance companies in Taiwan were permitted to invest up to 30 percent of their assets in TAIEX stocks.

FINANCIAL MARKET DISCUSSIONS

The Treasury Department has held bilateral talks with the Taiwan authorities, under the auspices of the American Institute in Taiwan, on financial services issues, including meetings in January and March 1990. Those meetings have served to highlight our concerns and impress upon the authorities the seriousness with which the U.S. views denials of equality of competitive opportunity in the local securities market. There has been some improvement in the securities environment as a result. For example, two foreign securities firms received approval in February 1990 to establish branches in Taipei. Further improvements are required and will be addressed in follow-up meetings.

CONCLUSION

Significant denials of national treatment exist despite minor improvement. There has been only minor improvement in Taiwan's treatment of foreign securities firms since 1986. Foreign securities firms are far from receiving national treatment. In February 1990, the authorities for the first time gave approval for two foreign (U.S.) securities firms to establish branches under strict qualifications. Otherwise, foreign firms are only permitted limited ownership in securities operations and may not establish subsidiaries nor enter into joint ventures. In addition, Taiwan prohibits direct foreign investment in local securities, the listing of foreign securities on the local market, and the offering of underwriting services by foreign firms.

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*U.S. dollar figures calculated at the following rates:

1989: $1 = NT$26.37 AA; 26.17 YE
1990: $1 = NT$26.39 (End-April 1990)

AA = Annual Average
YE = Year-End

25. Venezuela - Banking

SUMMARY

The Venezuelan financial system is small and has been declining as a percent of gross domestic product in recent years. At the end of 1989, total financial system assets were Bs 777.8 billion ($18.1 billion)*. Commercial banks held 70 percent of total assets in the financial system. Within the commercial banking system, there has been a steady concentration of assets, deposits and profits in the six largest private commercial banks.

U.S. banks do not receive national treatment. The U.S. presence in the retail banking system is small and has been diminishing due to a series of legal and operating constraints. Citibank is the only U.S. bank with a wholly owned operation. Citibank's network accounts for less than 1 percent of the system's assets and deposits. There have been some limited but no major improvements in the highly discriminatory conditions under which Citibank has been operating since at least 1975.

Recently, senior Government of Venezuela (GOV) officials have publicly recognized the need to modernize Venezuela's financial system and have indicated that a gradual opening of the financial system to foreign banks will be permitted. In the context of a World Bank financial sector loan, the GOV has announced plans to increase the permissible level of foreign equity participation in banks from 20 to 30 percent, and to allow foreigners to purchase bank shares from Venezuelans rather than exclusively from other foreigners. In 1990 foreign firms were allowed 100 percent ownership of nonbank financial institutions.

The Government presence in the financial system is both direct, through eight state run banks, and indirect, through an array of regulations. Prior to 1989, over-regulation by Government authorities and inappropriate macroeconomic policies stimulated extensive capital flight, and were responsible in part for the poor performance of the financial sector in mobilizing domestic savings.

The U.S. Treasury Department has expressed its concerns about Venezuela's denials of national treatment to Venezuelan officials, but only minor progress has been achieved with regard to banking. Significant denials of national treatment exist with only minimal improvement foreseen.

At year-end 1989, U.S. banks in Venezuela operated four branches with assets of $129 million, two subsidiaries with assets of $32 million, and 14 representative offices. This is roughly the same level of representation as in year-end 1985. At that time, one U.S. bank operated four branches in Venezuela with total assets of about $111 million. Twenty-one other U.S. banks maintained representative offices there. As of year-end 1985, U.S. banking corporations reported controlling interests in four subsidiaries or affiliates in Venezuela with total assets of approximately $72 million. One U.S. bank also had minority interest in two Venezuelan affiliates.

At the end of 1989, seven Venezuelan banks in the United States operated eight agencies with assets of $984 million, three branches with assets of $270 million, and one subsidiary with assets of $273 million. Venezuelan banks or individuals controlled six Edge corporations with assets of $806 million. Venezuelan banks maintain four representative offices in the United States. Excluding Edge corporations, this presence represents an increase of six operating offices and assets of $721 million since year-end 1985. At that time, five Venezuelan banks operated two branches, four agencies, and one representative office in the United States with total assets of $806 million. Two other banks maintained representative offices in the United States. Also as of year-end 1985, Venezuelan individuals reported majority interests in five U.S. banks with a total of 34 branches and aggregate assets of $1.3 billion. A minority interest was reported in one U.S. bank with two branches and total assets of $337 million. A Venezuelan interest also reported majority investments in four Edge Act/Agreement corporations and one Title XII investment company.

OVERVIEW

Domestic Banking Market

The legal and regulatory framework of the Venezuelan financial system is based on the principle of specialized and legally distinct financial subsectors including commercial banks, mortgage banks, investment banks (sociedades financieras), leasing companies, and the National System of Saving and Loan Associations. In practice, financial groups control entities in all the major financial subsectors. Total assets of the Venezuelan financial system at the end of 1989 were Bs 777.8 billion ($18.1 billion).

The financial system is increasingly dominated by six commercial banks which generally lend short-term (i.e., two years or less; although, most bank credits are 90 days or less). The 41 commercial banks maintain 1,643 branches in Venezuela, and their share of total financial sector assets has risen steadily from 60.5 percent in December 1984, to 70.6 percent in December 1989.

Investment banks, with approximately 10.8 percent of the financial system's total assets, have edged out the troubled mortgage bank sector (8.9 percent of total assets) as the second largest subsector. Representing only 3.1 percent of the financial system's assets, Venezuela's 31 leasing companies are a recent phenomenon. They have been growing rapidly and were regulated for the first time by the 1988 Banking Law. The Central Bank of Venezuela still does not include leasing companies in its statistics on the financial system.

Principal Components of the Venezuelan Financial System
December 1989
(Bs Billions)

	Number	Assets	Percent of Total
Commercial banks	41	549.326	70.6
Mortgage banks	16	69.958	8.9
Investment banks	29	84.472	10.8
Saving/loan associations	20	50.794	6.5
Leasing companies	31	2,000	
Other		21.200	3.2
TOTAL	137	756.550	100.0

Within the commercial banking system, assets are becoming more concentrated in the six largest financial institutions. The "Big Six" (Banco Provincial, Banco de Venezuela, Banco Mercantil, Banco Latino, Banco Union and Banco Consolidado) have increased their share of commercial bank assets from 50.3 percent in December 1984 to 56.7 percent in December 1989. More importantly, they hold 62.6 percent of the commercial banking system's deposits and earn 69.6 percent of total profits. Banco Provincial, the nation's largest bank, holds a 15.94 percent market share based on deposits. Most private observers believe the financial system will be further consolidated in coming years.

Commercial Bank Market Share Distribution
December 1989

Market Shares	Number of Banks	Percent of Deposits
More than 5 percent	6	62.5
Between 3 and 4.9 percent	1	3.8
Between 1 and 2.9 percent	14	25.4
Less than 1 percent	20	8.3
TOTAL	41	100.0

State Presence: There are eight banks with mixed or public ownership in the Venezuelan financial sector. Collectively, they hold assets of Bs 90 billion ($2.0 billion) or 16.4 percent of the commercial banking system's assets. The GOV has announced its intention to privatize three of the public sector banks, Banco Republica, Banco de Occident and Banco Italo-Venezolano, which collectively hold 4 percent of the banking system's assets. However, Banco Industrial de Venezuela, the major state bank with 66 percent of the public sector's financial assets, is not scheduled to be privatized, because it provides long-term development finance for projects that are high political priorities.

Regulatory Authorities: According to financial market sources, the Superintendency of Banks, which is the chief regulatory authority of the financial sector, is chronically understaffed, suffers from high personnel turnover and, consequently, is limited in its ability to supervise the financial system. The Banking Superintendency's ability to intervene in a troubled financial institution is contingent on the approval of the Ministry of Finance. In the past, interventions have often been tardy.

The Central Bank of Venezuela (BCV) by law sets maximum and minimum interest rates, and by resolution provides preferential rates and directs that 22.5 percent of bank portfolios be allocated to the agricultural sector. The GOV has recently made a commitment to adjust the maximum and minimum interest rates in response to the market demand for money and to phase down to 12 percent the required agriculture credit allocation. The GOV will submit a new

Bank Law to the Congress, which will establish a capital adequacy requirement of 5 percent of assets. The law will establish a universal banking system and a minimum capital requirement of $6 million for new banks. The proposed law will also eliminate limitations on commercial banks' non-Bolivar investments and borrowings (currently 5 percent of deposits).

The Venezuelan financial system is small and undercapitalized and has not attracted new capital investment in recent years. Capital and reserves at the end of 1989 totalled Bs 31.7 billion ($735.9 million). New capital injections have been limited due to low profits and inadequate returns on capital compared to other investments. Total commercial bank indebtedness was 16.8 times capital base (i.e. debt to capital and reserves) in December 1989. Commercial bank assets as a percentage of gross domestic product have fallen from 110.6 percent in December 1983 to 46.9 percent in 1988.

Another way to look at the size of the Venezuelan commercial banking system is to note that total assets at the end of 1989 equalled Bs 546.1 billion ($12.7 billion), equivalent to the assets of a mid-size regional U.S. bank. Commercial bank deposits at the end of 1989 totalled Bs 385.8 billion ($9.0 billion). In contrast, Venezuelan deposits abroad have been estimated at several times this amount. During the 1979-88 period, inappropriate macroeconomic policies, such as unrealistic exchange rates and negative real interest rates, encouraged capital flight and in turn contributed to the lack of real growth in the financial sector.

U.S. Presence in the Market

The U.S. and other foreign presence in the retail banking system is minimal and has been diminishing due to highly restrictive and discriminatory operating and legal constraints in effect since 1975. Citibank's retail banking presence in the Venezuelan system is practically synonymous with foreign presence in the sector, as the only other wholly owned foreign bank is Banco do Brasil, which began operations in 1978. However, Banco do Brasil's assets are only 5.2 percent of Citibank's. Together, these two foreign banks represent less than 1 percent of total financial system assets and deposits.

Foreign Bank Presence in the Venezuelan Banking System
December 31, 1989
(Bs Billions)

Banks	Assets	Percent of Total	Deposits	Percent of Total
Citibank	3.49	0.62	1.10	0.84
Banco do Brasil	0.19	0.03	0.02	0.01
TOTAL	3.68	0.65	1.12	0.85

The 1975 banking law required established foreign banks to either reduce ownership to below 20 percent of total equity or, as in the case of Citibank, retain full equity ownership and operate under discriminatory conditions (discussed below).

Under the 1975 law, the French banks Credit Lyonnais and Banque Sudameris elected to sell down to a less than 20 percent share in Banco Provincial and Banco Latino, respectively. Bank of New York also holds a less than 20 percent equity share in an investment bank, Sociedad Financiera Consolidado, part of the Banco Consolidado Group. Extebandes, a small multinational bank with reported total assets of Bs 1.2 billion ($27.9 million) in December 1989, has capital subscribed by investors from Spain and Andean Pact Members. For legal purposes it is treated as a national bank.

As of December 1989, 78 foreign banks maintained representative offices in Venezuela, 14 of which were U.S. banks, down from 25 in 1985. Representative offices engage in a variety of financial activities including trade finance, arranging medium- and long-term dollar financing, clearing wire transfers, servicing corporate clients, and arranging debt-equity swaps.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The Venezuelan financial system has been highly protected since the early 1960s. Since then, new banking licenses have not been issued and established foreign banks have not been allowed to expand their existing branch networks. These restrictions foreshadowed the eventual "Venezuelanization" of the financial system codified in the 1975 General Banking Law.

The 1975 General Banking Law and the 1988 General Banking Law renewal stipulated that the capital of any new bank must be at least 80 percent Venezuelan-owned, effectively preventing entry by foreign banks. Foreign banks established prior to the 1975 law were required to reduce their equity ownership to below 20 percent or retain their foreign ownership and operate under highly discriminatory conditions. Citibank chose to retain full equity ownership under the 1975 law. Since 1975, foreigners have only been allowed to acquire shares in an existing bank by purchasing the shares from another foreigner. The following operating restrictions apply only to foreign banks "grandfathered" by the 1975 law.

-- Foreign banks cannot increase the number of branch offices existing since 1975. (Citibank has four branch offices in Venezuela.)

-- The capital of foreign banks cannot be increased by new investment beyond the minimum capital requirement of Bs 120 million ($2.7 million). Capital can be increased through an increase in reserves via retained earnings.

-- Foreign banks may not maintain liabilities exceeding 14 times paid-in capital and reserves (i.e. leverage ratio). National banks, on the other hand, are allowed to maintain liabilities of 20 times paid-in capital plus reserves.

-- Foreign banks may not receive savings deposits or issue negotiable certificates of deposit.

-- Foreign banks cannot purchase foreign exchange from the Central Bank.

Two 1989 administrative decisions by Superintendancy of Banks provided limited improvement in the treatment of foreign financial institutions. Foreign banks' leverage ratio was increased from six to 14 times capital (although still less than the 20:1 maximum ratio allowed national banks). The second improvement involved a decision to allow Citicorp to retain 100 percent equity in its local leasing company rather than be forced to sell down to a 20 percent equity position. At the same time, however, the GOV reduced the overall leverage ratio of the leasing company from 20:1 to 6:1.

Senior GOV officials have announced recently their intention to introduce changes to the Banking Law in 1990 which, if approved by Congress, could be seen as a first step to a gradual opening of the financial sector. Under the draft proposed banking law, the GOV would lighten some of the restrictions on foreign bank entry. Specifically, the GOV would allow up to 30 percent foreign ownership of any local bank. (Currently foreign investors may only purchase shares in local banks from other foreigners, the total of which cannot exceed 20 percent.) Thus, foreigners would be able to purchase shares from Venezuela owners. In addition, in 1990 the GOV allowed foreigners to establish up to 100 percent ownership of financial institutions other than commercial banks.

Despite recent improvements, the general effect of the severe operating restrictions on foreign banks is to undermine their ability to compete in the retail banking market. Foreign presence in the retail banking sector is minuscule and can be expected to contract even further unless current conditions are substantially improved.

FINANCIAL MARKET DISCUSSIONS

In September 1988, the Acting Secretary of the Treasury wrote the Finance Minister of Venezuela to express the U.S. Government's strong objections to Venezuela's denials of national treatment to foreign banks. The letter specifically noted the freeze on new entry and branching and the discriminatory leverage requirement imposed on foreign banks. The Government of Venezuela took no action in response to the specific concerns noted in this letter. Treasury Department officials have raised these and other national treatment concerns subsequently in meetings with Venezuelan officials, but only minor progress has been achieved with regard to banking. However, more opportunities may be available to subsidiaries of foreign firms engaged in capital market activities.

CONCLUSION

Significant denials of national treatment exist with only minimal improvement foreseen. Venezuela places severe restraints on foreign banks' establishment and operations. However, Venezuelan officials have recently acknowledged the need to modernize the country's financial system and have indicated that a gradual opening to foreigners will be permitted. In the context of a World Bank financial sector loan, the GOV announced plans to increase the permissible level of foreign equity participation in commercial banks from 20 to 30 percent and allow foreigners to purchase bank shares from Venezuelans rather than exclusively from foreigners. In 1990 foreign firms were allowed to own 100 percent equity in domestically incorporated nonbank financial services firms. It remains to be seen how these new developments will unfold in actual practice.

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*U.S. dollar figures calculated at the following rates:

1989: $1 = Bs 43.0787 YE
1990: $1 = Bs 44.8588 (End of April 1990)

YE = Year-End

26. Venezuela - Securities

SUMMARY

For a variety of reasons, the Venezuelan securities market has not been an important source of financing for the private sector. The market is small with only about 20 stocks actively traded. Three stocks account for approximately 30 percent of stock transactions. Capital increases of companies registered with the National Stock Commission (CNV) in 1988 totalled Bs 11.4 billion ($786 million).[*] New shareholders subscribed less than one percent of these capital increases. Total secondary market transactions in 1989 were a mere Bs 13 billion ($375 million). Public bonds have increasingly dominated the small, volatile secondary market and in recent months have accounted for 85 percent of total transactions.

Direct U.S. presence in the local capital market as of June 1990, consists of only Citicorp, which bought a seat on the Caracas Stock Exchange in 1988. Other large U.S. banks and other financial entities have participated indirectly in securities market activities from offshore or by using local Venezuelan firms. Decree 727, promulgated in January 1990, liberalized foreign investment rules and removed some barriers to Venezuela's securities market which could potentially result in greater access. Foreign corporations based in Venezuela can now issue any type of stock, bond or commercial paper on the stock exchange after meeting national regulatory and legal requirements. Foreigners can also purchase any amount of stock of any company listed on the exchange, except in those cases where Venezuelan law places limits on foreign equity participation. The major practical limitation applies to bank stocks, in which foreign participation cannot exceed 19.9 percent of capital and purchases must be made from another foreign investor. The Government, however, has announced plans to modify these restrictions.

There are signs of possible improvement which may lay the groundwork for an important expansion of Venezuela's traditionally small capital markets. These include: the opening of the local capital market to foreign participation; the Central Bank of Venezuela's recent issuance of large amounts of zero-coupon bonds; the possibility that privatization of state enterprises may, in some cases, be conducted through the local stock exchanges; and the recent regulation on the issuance of commercial paper.

There have been mixed results in movement toward national treatment but significant restrictions remain on the establishment of bank branches and subsidiaries.

OVERVIEW

Domestic Securities Markets

The Caracas Stock Exchange has been in operation since 1947. A second regional exchange was opened in Maracaibo in 1986, but its volume is less than 2 percent of the transactions handled by the Caracas Stock Exchange.

As of mid-year 1990, there were 48 seats on the Caracas Stock Exchange, with prospects of adding seven seats later in 1990. At a March 1990, public auction of five seats on the Caracas exchange, a bid as high as Bs 8 million ($185,000) was made. The minimum capitalization of a broker or brokerage firm is Bs 10 million ($232,000). Membership on the stock exchange is open to both individuals and legal entities. Some local commercial banks have recently purchased seats in their own names.

For a variety of reasons, the Venezuelan private sector has not used equity finance as a significant source for capitalization. Among these reasons are a traditional reluctance of family enterprises to cede even minority control to outsiders, an unwillingness to meet public disclosure requirements, access to subsidized government credits or to commercial credit provided by financial entities linked to an industrial group, access to abundant external credit (prior to 1983), double taxation of dividends and the hazards of a small, concentrated and volatile secondary market. Additionally, during the 1980-88 period, the Government banking authorities often set interest rate ceilings below the prevailing inflation rate, stimulating excessive commercial credit demand.

In 1980, private companies raised Bs 400 million ($93 million) via stock and bond offerings. During the same year, local banks lent Bs 10.4 billion ($2.4 billion) and the private sector borrowed abroad $711 million in long-term capital. Consequently, stock market financing represented less than 3 percent of the private sector's available financial resources (not including retained earnings) in 1980.

In 1989, the private sector issued Bs 3.8 billion ($109 million) in stocks and bonds. Long-term external credit for the private sector had virtually dried up. Due to a recession, the commercial banks increased nominal lending to the private sector by Bs 38.3 billion ($1.1 billion) in 1989. Even in this depressed situation, the private sector did not rely on the stock market. Only 112 companies were listed on the Caracas Stock Exchange. Of the 112 companies, only four had outstanding stock valued at greater than Bs 1 billion ($69 million). Private analysts estimated that in mid-1990, no more than 20 stocks were actively traded and that total stock ownership was distributed among 50,000 individuals.

The aversion to outside shareholders is illustrated by the fact that in 1988 new shareholders contributed less than 1 percent of total capital increases. "Public Offerings" of stock are largely placed with existing shareholders.

The small secondary stock market is increasingly dominated by public bonds, many of which are bought by commercial banks and insurance companies to meet legal requirements of keeping a portion of liquid reserves in public bonds. In 1980, public bond sales of Bs 480.6 million ($112 million) represented 53.8 percent of total secondary market transactions. As significant external credit sources decreased, internal debt doubled from Bs 42.2 billion ($5.6 billion) at the end of 1984, to Bs 84.3 billion ($5.8 billion) at the end of 1988. Internal debt as a share of gross domestic product in constant 1984 bolivars rose from 12.1 percent in 1984 to 17.4 percent in 1988. Public bonds' share of secondary market trading increased to 70.6 percent of total 1989 secondary market transactions and to 85 percent of total transactions during the first three months of 1990. Public sector borrowing appears to be crowding out private borrowing in the local capital market.

Distribution of Stock Market Operations in 1989
(Bs millions)

INSTRUMENT	AMOUNT	PERCENTAGE
Public Bonds	9,189	70.6
Private Stock	3,471	26.8
Private Bonds	339	2.6

Three companies, Electricidad De Caracas, Sivensa (Specialized Steel) and Banco De Venezuela, accounted for 30 percent of total stock transactions in the April-June 1989 period. The 10 most active stocks accounted for 45.7 percent of total stock transactions during this period. Six of these 10 stocks belong to commercial banks.

Another underlying characteristic of the secondary market has been its volatility. The Caracas' stock market composite index rose 68.2 percent in the January-June 1987 period, remained practically stationary in the January-June 1988 period, and then, fell 43 percent during the January-June 1989 period.

Regulatory Authority: The National Stock Commission (CNV), attached to the Ministry of Finance, is the chief regulatory authority of the local stock exchanges. The CNV is limited in its ability to regulate the market because it has no legal capacity of its own to sanction violations of legal or regulatory statutes. In addition, maximum administrative fines contained in the 1975 capital market law have not been updated and appear to be more of a nuisance than a deterrent.

U.S. Presence in the Market

U.S. presence in Venezuela's small capital markets is modest. Citicorp, which has a subsidiary and four offices, purchased a seat on the Caracas Stock Exchange in 1988 and recently increased its equity portion in its local brokerage house from 49 to 90 percent. As of June 1990, Citicorp was the only U.S. bank to own a stock exchange seat. In addition to the Citicorp subsidiary, as of December 1989, fourteen U.S. commercial banks and at least two U.S. investment banks had representative offices. Most of their activities are reportedly related to consulting and investment advisory activities. Other U.S. commercial and investment banks participate indirectly in the local capital market, either from offshore or by using local Venezuelan firms, by underwriting and placing dollar-denominated public sector debt instruments with local and foreign clients.

The promulgation of Decree 727 of January 1990, which liberalized foreign investment in general, removed some legal barriers to foreign participation in the local securities market. As a result, U.S. financial institutions may find a wide range of securities-related activities available to them.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks are not allowed to establish new subsidiaries or branches, although foreign firms may open representative offices.

In the past, U.S. and other foreign financial firms could participate in Venezuelan securities market by: establishing a representative office; buying a seat on the stock exchange (although the member firm was required to have some minority local content); operating from offshore; or using a local Venezuelan firm to engage in market activities locally. As a result of Decree 727, foreign firms will reportedly be able to establish local investment companies, which should permit them greater access to Venezuela's securities market.

Under a World Bank financial sector loan to Venezuela, by mid-1991, the Government of Venezuela (GOV) will submit revisions to the Bank Law to allow the Government to authorize foreigners to acquire up to full ownership of, or to establish new, financial institutions other than commercial banks, (i.e., local investment companies) subject to operational criteria established by the Government. The GOV has noted that the establishment of the criteria is not intended to discourage foreign investment in these institutions.

Prior to 1990, American banks interested in securities and investment banking activities in Venezuela had to obtain approval from SIEX (Sistema de Inversiones Extranjeras -- the government regulatory agency which previously supervised foreign investment). However, as a result of Decree 727, they need only inform SIEX of such activities.

Foreigners can purchase any amount of publicly traded stock, provided that the percentage of foreign-owned equity in any company does not exceed the statutory maximum. In the case of banks, foreign participation cannot exceed 19.9 percent of equity which must be purchased from another foreign investor. The Government, however, has announced plans to raise this participation to 30 percent and to drop the requirement that equity be purchased from another foreigner. Foreign corporations located in Venezuela may now issue any stock, bond or commercial paper on the domestic market as long as it complies with the regulations established by the National Stock Commission and the provisions of the Capital Markets Law.

In addition to the opening of the local securities markets to foreign participation, other recent events may lay the groundwork for growth in the local capital markets. Such events include: the Central Bank of Venezuela's November 1989 decision to place large amounts of zero-coupon bonds in the stock market (which contributed to record sales); the recent issue of CNV regulations allowing corporations to place commercial paper, which may open a new financing alternative for some corporations; and the possibility that the privatization of some state enterprises may be carried out through public stock issues.

FINANCIAL MARKET DISCUSSIONS

In September 1988, the Acting Secretary of the Treasury wrote the Finance Minister of Venezuela to express the U.S. Government's strong objections to Venezuela's denial of national treatment to foreign banks (see chapter on Venezuela-Banking). The letter specifically noted the freeze on new entry and branching and the discriminatory leverage requirement imposed on foreign banks. The Government of Venezuela took no action in response to the specific concerns noted in this letter. Treasury Department officials have raised these concerns subsequently in meetings with Venezuelan officials, but only minor progress has been achieved with regard to banking. However, more opportunities may be available to subsidiaries of foreign firms engaged in capital market activities.

CONCLUSION

Despite mixed results in movement toward national treatment, significant restrictions remain on the establishment of bank branches and subsidiaries. Foreign access, however, is relatively easy via representative offices, which may engage in a variety of consulting and investment advisory work. Foreigners can also purchase any amount of stock on the local exchange, except in the commercial bank sector, and may purchase a seat on the exchange, provided the member company contains some minority local content. Foreign corporations based in Venezuela can now issue any type of stock, bond or commercial paper on the stock exchange after meeting national requirements. Some American firms interested in securities and investment banking maintain that they have been able to engage in some of these activities, primarily, however, from offshore or by using a local Venezuelan firm. The January 1990 promulgation of Decree 727 could result in greater direct foreign access to Venezuelan capital markets, through the formation of wholly owned domestic subsidiary companies of a foreign financial institution. Although the local capital market has been small historically, the opening of the market to foreigners, the issuing of Central Bank zero-coupon bonds, and the privatization of state enterprises may expand this market.

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[*] U.S. dollar figures calculated at the following rates:

1980: $1 = Bs 4.2925 AA
1984: $1 = Bs 7.50 YE
1987: $1 = Bs 14.50 AA, YE
1988: $1 = Bs 14.50 AA, YE
1989: $1 = Bs 34.7 AA
1990: $1 = Bs 43.1596 (Average March 1990 rate)

AA = Annual Average
YE = Year-End

27. Australia - Banking

SUMMARY

Although 42 foreign banks were invited in February 1985 to submit applications to establish trading bank operations in Australia, after examination of their applications the Australian Government authorities granted licenses in 1985 to 17 foreign banks, including four U.S. banks. The applications of three U.S. banks were rejected. The Government of Australia is unwilling to issue trading bank licenses to foreign banks at this time. Proposals for the establishment or acquisition of merchant banks or nonbank financial institutions are readily approved under the Government's foreign investment policy unless judged by the Government to be contrary to the national interest. Merchant banks can undertake most of the activities of trading banks. Licensed foreign banks have the same operating privileges as Australian banks.

The Australian financial market is served by four major nationwide full-service banks, a score of regional banks, and many nonbank financial institutions. Privately owned full-service banks operate under the authority of the Banking Act of 1959. The largest full-service bank, the Commonwealth Bank, is owned by the Federal Government and operates under the Commonwealth Bank Act of 1959, but is also subject to the Banking Act. It operates in the same manner as other banks. As of January 1990, there were 39 banks authorized under the Banking Act, as well as the Commonwealth Bank and five state banks. In May and August 1990, agreements were announced which will lead to the integration into other banks of one foreign-owned bank and one state bank.

Merchant banks hold the greatest share of the nonbank assets and can engage in virtually all the business carried out by the banks, except direct check clearing services. They may, however, participate in the check clearing system through agency agreements with banks. There are 158 merchant banks, which form 116 operating groups, in Australia.

Nonbank financial institutions also include pastoral (agricultural) finance companies, building societies, credit cooperatives, finance companies, intra-group financiers and other financial corporations. These nonbank entities must submit statistics to, but are not supervised by, the Reserve Bank under the Financial Corporations Act (1974).

Since 1981, the number of full-service banks has expanded from 11 to 34, including 16 foreign-owned trading banks, among which are four U.S.-owned banks. A fifth U.S. bank has chosen not to take up its license.

Since the liberalization of foreign investment policy for nonbank financial institutions, including merchant banks, insurance companies, and stockbrokers, proposals to establish new nonbank financial businesses worth over A$ 10 million, or to acquire existing ones of A$ 5 million, are examined by the Government and normally approved without the need to show economic benefits or provide for Australian equity, unless judged contrary to the national interest. Smaller proposals are not examined.

While deregulation has continued, only limited additional progress toward national treatment has been made.

As of year-end 1989, U.S. banks in Australia operated 32 subsidiaries and affiliates (including merchant banks) with assets of $15.2 billion. Although this presence represents a net decrease of nine subsidiaries, it represents a net increase of $10.4 billion in U.S. bank-controlled assets since year-end 1985. At that time, there were 41 subsidiaries of U.S. banks in Australia with total assets of $5.6 billion.

At the end of 1989, seven Australian banks operated six agencies, with assets of $560 million, and 12 branches with $4.2 billion in assets in the United States. Australian banks maintain 12 representative offices in the United States. This presence represents a net increase of one branch and three agencies and of $1.6 billion in assets since year-end 1985. At that time, five Australian banks operated 11 branches, three agencies, six international banking facilities, and six representative offices in the United States with total assets of $2.6 billion. Three additional Australian banks had representative offices in the United States.

OVERVIEW

Domestic Banking Market

The Australian economy is characterized by a large service sector including a well established banking industry. Banking services account for more than 2 percent of gross domestic product and employ more than 170,000 people.

The Australian financial market includes banks and other nonbank financial institutions, with banks having the more important role in the economy. Leaving aside a discussion of the role of merchant banks, it is useful to adopt the classification scheme used by the Reserve Bank of Australia to examine trading banks. This scheme is based on whether the particular bank or a direct predecessor was operating in 1981, whether the bank is one of the four dominant deposit taking institutions and whether the institution is owned by a foreign entity, or a public or private Australian entity.

Classified in this fashion, there are three privately owned Australian trading banks established before 1985, five new Australian trading banks established after 1985, one federally owned trading bank operated on a commercial basis, five state-owned, and finally 18 foreign-owned trading banks. Market share is distributed as follows:

Market Share of Trading Banks
Operating in Australia
(as of January 31, 1990)

Type of Institution	Numbers of Banks	Total Assets (A$ Millions)	Percent of Total Assets
Banks established before Dec. 1981			
Major Banks	4	213,051	66.1
State-owned banks	5	54,154	16.8
Other established banks	6	7,094	2.2
New banks since 1981			
Domestically owned	6	16,448	5.1
Foreign-owned banks	18	31,393	9.8
(of which U.S.-owned)	(4)	(12,798)	(4.0)
All trading bank assets	39	322,140	100.0

Source: Reserve Bank of Australia Bulletin

After restrictions on the establishment of new trading banks were eased under the Banks Act of 1985, 22 new banks opened their doors between 1985 and 1989. Eighteen of these are foreign-owned, four of which are U.S.-owned. The new entries increased competition and as a result, profit margins on the traditional activities of the established banks were reduced significantly. In response, the older banks broadened their services and became more cost conscious. Service fees were introduced on some activities that were previously subsidized by other bank operations. Offshore operations were also expanded, a process that is continuing.

The five state government-owned banks also have responded to competition, by diversifying into other states, and establishing overseas branches.

Generally, the new foreign-owned banks have avoided the heavy infrastructure costs of retail banking and have focused on providing wholesale corporate banking services. Five of the new foreign banks have increased capital via an Australian minority interest.

Under the Banking Legislation Amendment Act of 1989, distinctions between trading banks and savings banks were removed. Thus liquidity reserve requirements for savings banks are being brought into line with the requirements for trading banks.

In 1988, the Reserve Bank introduced a risk-based approach to capital adequacy in order to reflect the varying risk profiles among banks and the expansion of off-balance sheet business. Since then, trading banks have been required to maintain, for both the bank itself and its consolidated group, a minimum ratio of capital to risk-weighted assets of 8 percent. At least 4 percent should be "tier 1" capital as defined by the Basle Concordat on Capital Adequacy.

Moves by banks, particularly merchant banks, to tighten controls on the risks entered into by their nonbank subsidiaries have led to a redirection of business from nonbank subsidiaries to parent banks. This process contributed substantially to the growth in market share recorded for newer domestically owned banks.

Aggregate, gross off-balance sheet business is about three times the size of the trading banks' consolidated group balance sheets. Interest rate related transactions such as forward exchange contracts, interest rate and currency swaps, and forward rate agreements account for over 85 percent of gross off-balance sheet business. Within Australia, the new foreign trading banks have a substantially higher share of aggregate off-balance sheet business than of on-balance sheet assets. In part, this reflects their concentration on corporate banking. In contrast, the state banks have a relatively small share of such business because of their low level of activity in foreign exchange markets and concentration on consumer and small business accounts.

Asset Structure: The composition of assets on trading banks' Australian books is outlined below. The emphasis placed by new foreign-owned trading banks on corporate lending is evident from their concentration on commercial categories and is based on expertise acquired when most of these organizations operated as merchant banks before becoming full-service banks. The direct lending of established and other privately owned and state banks is relatively concentrated in housing and personal lending, a reflection of their extensive retail banking operations.

Composition of Assets on Trading Banks'
Australian Books
(as of September 30, 1989)
Percent of Group Total

	National	State	Foreign
Claims on Public Sector (a)	11.5	9.5	7.9
Balances with Fin. Intermed.	4.3	10.7	9.2
Lending (Total)	62.2	50.6	51.7
Housing	(25.5)	(18.7)	(11.5)
Personal	(9.5)	(12.3)	(3.8)
Commercial	(22.3)	(14.5)	(25.0)
Other (b)	(4.9)	(5.1)	(11.4)
Bills/Acceptances	3.5	12.6	13.0
All Other	18.5	16.6	18.2
TOTALS	100.0	100.0	100.0

(a) Includes cash, reserves, and public securities.
(b) Includes discounted bills, promissory notes, leasing finance and lending to the Government.

Establishment Rules: In law, there are no barriers to establishment of full-service retail banks in Australia. In practice, the Government will not accept applications from foreign interests to establish trading banks in Australia. (This policy is reviewed periodically.)

Domestic entities that can meet banking requirements may apply for banking licenses at any time. Joint venture banking proposals between foreign and Australian interests also would be considered, although no applications of that type have been reported.

All the successful applicants for trading bank licenses already had established merchant bank or joint venture operations in Australia, except for the Bank of China, which was invited by the Government to return because it had previously operated in Australia from 1942 to 1972. Previous ties to Australia were not a requirement for consideration.

Under the prudential guidelines established by the Reserve Bank, foreign banks established in Australia are required to set up subsidiaries instead of branches. The Reserve Bank also places foreign banks on the same operational footing as existing domestically owned banks with respect to their obligations and responsibilities under the relevant commonwealth and state laws and other policies.

Merchant Banks: There are 158 merchant banks operating in Australia. Since they do not offer check clearing services, they are at a disadvantage in providing retail customer service. Instead, they provide a broad range of corporate and trade-related services to business customers, and the largest can offer global services and access to money markets. Smaller merchant banks specialize by filling special niches such as providing expertise in trade or financing specific types of transactions either in Australia or between Australia and other specific countries. Unlike trading banks, which must meet prudential requirements in Australia, merchant banks can operate as branches of foreign banks with prudential requirements met by the parent bank. They cannot, however, use the word "bank" in their business name.

Because they do not provide retail services, some merchant banks are very small. Merchant banks can be easily expanded or contracted. Economic swings, therefore, have less effect on them than on retail banks. Other than prudential and bookkeeping requirements, merchant banks are free to operate as business needs dictate.

Recent History of Market Share Trends
Percent Total Assets

	Dec. 1984	Dec. 1987	Dec. 1988
Merchant Banks	10.5	12.5	12.5
Finance Companies	12.5	9.0	8.5
Building Societies	10.5	6.0	5.5
Credit Unions	2.7	2.4	1.9
Authorized Dealers	1.0	0.8	0.8
Other	4.8	5.8	5.8

Source: Reserve Bank of Australia Bulletin

U.S. Presence in the Market: Two foreign-owned banks, the Bank of New Zealand and Banque National de Paris (BNP), are generally included in the category of "established banks," because they were present in Australia before the Banking Act of 1945 effectively closed Australia to the entry of foreign-owned banks. These banks were originally formed to facilitate trade between Australia and New Zealand and France, respectively. Most of the business conducted by these two banks is merchant banking.

The remainder of the foreign-owned banks are new to the market, having been admitted in 1985. There are 16, four of which are U.S.-owned banks (Bank of America, Australia Ltd., Bankers Trust Australia Ltd., Chase Bank Ltd., and Citibank Ltd.). A fifth U.S. bank, J.P. Morgan, was approved on the same basis as the others in 1985, but never took up its license.

High infrastructure costs have discouraged U.S.-owned banks from becoming heavily involved with retail banking. Only Citibank has established a consumer banking network, resulting in 14 Australian branches, 1,670 local employees, and total assets exceeding $A 7 billion ($5.4 billion calculated at a June 1, 1990 exchange rate of $1=$A1.2998).[*] To overcome lack of infrastructure, Citibank contracted with a nationwide pharmaceutical firm to use its neighborhood outlets as deposit collection agents. Arrangements with other banks and building societies to share automated teller machines provided

Citibank with over 4,000 customer access points without major investments. Although they have an appropriate license, the other U.S.-owned banks do not provide full trading bank services and have not sought to compete with the "big four" at the retail level. The other banks operate primarily as merchant banks and their customers are nearly all corporate or investment funds. Having a trading bank license improves a bank's customer relations, credit status, and tax position. All of the U.S.-owned trading banks were profitable in 1989.

Comparative Performance of Foreign and Domestic Banks
(Percent change as measured in Australian dollars)

	1988		1989	
	foreign	domestic	foreign	domestic
Increase in total assets	12.20	20.60	15.20	21.90
Increase in consolidated operating profit	34.20	46.90	-149.96	12.02
Operating profit to average net assets	6.25	13.47	-2.94	12.40
Net interest income to average total assets	2.33	3.40	2.14	3.19
Operating expenses	3.47	3.28	3.94	3.02

Source: KPMG Peat Marwick Hungerfords
1989 Financial Institutions Survey

Return on Australian investment is not the sole objective for foreign banks locating there. As the banking day ends in North America, the next banking day is beginning in Australia. Multinational banks link their offices in Australia into networks that can carry on transactions around the clock. The contribution of an Australian office may not show on an Australian bank's balance sheet but could be important in a global context.

Except for Citibank, which gets an important portion of funds from interest bearing accounts and professional money markets, sources of funds for other U.S. banks operating in Australia come primarily from advisory services, trading, foreign exchange markets and fund management. Other foreign banks seem to depend more than their U.S. counterparts for financing from their parent banks. The provision of trading services also seems more important to many of the third-country banks.

Some of the other foreign banks are expected to reduce their operations in 1990, following the slowdown in the Australian economy. British and Hong Kong banks reportedly had a disappointing year in 1989. Although Japanese and German banks apparently met 1989 goals, their overall performance was sluggish.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no legal barriers to establishment of full-service retail banks (trading banks) in Australia. In practice, however, the Government of Australia denies potential foreign entrants national treatment by not accepting their applications for trading bank licenses. Foreign banks may establish a merchant bank at any time. The most important difference between trading banks and merchant banks is that the latter may not accept demand deposits or clear checks. Established U.S.-owned banks receive national treatment.

DOMESTIC SECURITIES MARKET

The Australian Stock Exchange Limited (ASX) is incorporated under the Australian Stock Exchange and National Guarantee Fund Act of 1987, an act of Federal Parliament. The ASX is an amalgamation of the stock exchanges of Adelaide, Brisbane, Hobart, Melbourne, Perth, and Sydney, each of which is incorporated and has a history of service of approximately 100 years. ASX is a nonprofit corporation. Australia has an options market (the Australian Options Market) established in 1976 which trades stock and precious metal options. In 1985, the Australian Financial Futures Market Pty. Limited (AFFM) was established in Melbourne to trade futures contracts for individual stocks and, more recently, index-based contracts. In 1989, the ASX ranked sixth in the world in market capitalization (domestic corporations basis) and trading volume. Market turnover was A$ 37.6 billion ($47.4 billion) in the year ending June 30, 1988, and A$ 26.6 billion ($35.2 billion) in the following year. Purchases and sales of equities by foreigners on the ASX account for approximately 35 percent of total turnover, ranging since 1985 between a low of 32.7 percent and a high of 44.9 percent. Two U.S. brokerage houses (Merrill Lynch and Prudential-Bache) are members of the ASX through their Australian branches. Citicorp wholly owns an Australian broker which is a member. The provisions of ASX Article 37(2)(e) are intended to ensure access to the ASX on the basis of reciprocal access by ASX members to foreign stock exchanges. U.S. firms have not reported discriminatory treatment in connection with the ASX.

CONCLUSION

While deregulation has continued, only limited additional progress toward national treatment has been made. Following significant improvement in 1985 when trading bank licenses were offered to five U.S. banks (four were utilized and three applications were denied), little additional progress has been made toward national treatment. Additional trading bank licenses are not expected to be offered to foreign interests in the foreseeable future although more limited licenses are available. Deregulation, however, has continued. The interest rate ceiling on new housing loans was removed in 1986; the savings bank reserve asset ratio was reduced in 1987; and the distinction between savings banks and trading banks was removed in 1989. With respect to nonbank financial institutions, the 50 percent limit on foreign ownership of money market dealers was removed in 1990 and the requirement that ownership be spread among several owners was abolished.

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* U.S. dollar figures calculated at the following rates:
1988: $1=$A .7940 (end of June 1988)
1989: $1=$A .7553 (end of June 1989)

28. People's Republic of China - Banking

SUMMARY

The banking sector in the People's Republic of China (PRC) is dominated by the state-owned banks. There are more than 90,000 branches nationwide of the State's four specialized banks, two comprehensive banks, and one wholesale bank. In addition, there are approximately 60,897 rural credit cooperatives and 3,265 urban credit cooperatives.

The scope of business permitted to foreign financial institutions in China is extremely limited. Foreign banks are allowed to open branches only in the five Special Economic Zones and Shanghai's Pudong Development Area. These branches may not take local currency deposits or extend local currency loans. Elsewhere, foreign banks may open representative offices, but these offices may not engage in any direct profit-making business.

Despite the lack of national treatment and the challenge of doing business in China, the U.S. banking presence in China was growing and the banks were generally profitable through mid-1989. In the current political and economic climate, however, U.S. financial institutions are reticent to expand in China. Most judge the chances of significant liberalization of financial markets to be slim for some time to come.

Ten U.S. banks are represented in China. At the end of 1989, one Chinese bank operated three branches with $927 million in assets in the United States. One Chinese bank maintains a representative office in the United States.

There has been slight improvement, but significant denials of national treatment remain.

OVERVIEW

Domestic Banking Market

The banking sector in the People's Republic of China is dominated by the state-owned banks. Under China's Central Bank, the People's Bank of China (PBC), there are four specialized banks and two comprehensive banks. The largest specialized bank, the Industrial and Commercial Bank of China (ICBC), primarily provides working capital loans to urban industries and businesses. The People's Construction Bank of China (PCBC) provides commercial loans for investment in fixed assets and funds Ministry of Finance infrastructure projects. The Agricultural Bank of China

(ABC) provides financing in rural areas, including the funds needed for crop procurement by the State. The Bank of China (BOC) is the PRC's main foreign exchange bank. To foster competition, the Government has in recent years allowed some overlap of the specialized banks' activities; although, for the most part, each bank's activities continue to be concentrated in its particular market.

China's two comprehensive banks are full-service banks which operate much the same as do commercial banks in most Western countries. In 1987, the Bank of Communications (BOCOMM) reopened as a full-service bank. China Investment Bank (CIB), established in 1981, is a government-owned wholesale bank specializing in mobilizing funds from abroad, principally from the multilateral development banks, to invest domestically. Administratively, it is under the People's Construction Bank of China. CITIC Industrial Bank, also established in 1987, is a full-service bank wholly owned by China International Trust and Investment Corporation.

Total assets of the banking system were RMB 1.362 trillion ($288.4 billion)* as of December 31, 1989.

Detailed statistics on the assets of the state-owned banks are not available. The following table summarizes available information:

Assets of China's State-Owned Banks as of December 31, 1989
(RMB Billions)

Institutions	Total Assets	Total Loans	Branches(1)
BOC	677	248	595
ICBC	773	575	30,000
PCBC	407	278	13,539
ABC	373	306	50,777
BOCOMM	53	28	45
CIB	10	8	60
CITIC IB	16	10	6
Total	2,299	1,453	94,869

Source: People's Bank of China, bank annual reports
(1) The number of branches varies depending on how a branch is defined. Figures were provided by People's Bank of China.

After the establishment of the People's Republic of China in 1949, most foreign banks closed their offices in China. The four that remained in Shanghai, none of which are American, are the only banks allowed to operate branches outside of the Special Economic Zones.

Foreign financial institutions began returning to China in the late 1970s through the early 1980s. Chinese-owned banks based in Hong Kong (i.e., Bank of Kwangtung, Nanyang Commercial Bank) were the first foreign registered banks to set up branches in the Shenzhen Special Economic Zone (SEZ). Western and Japanese banks began setting up representative offices, mainly in Beijing, starting in 1980. In April 1985, the State Council published regulations governing foreign and joint-venture banks. The PBC has so far has approved the establishment of branches of foreign financial institutions in the SEZs only.

There are now 34 branches of foreign financial institutions in China. These include five branches (four in Shanghai, one in Xiamen) of non-U.S. foreign banks which existed prior to 1949 and were allowed to continue operations after the foundation of the PRC. There are also two Hong Kong-based Chinese-owned insurance company branches. The other 27 branches are foreign bank branches approved to operate in the SEZs.

In addition to branches, there are a total of 204 representative offices of foreign financial institutions throughout China. Japanese banks and financial institutions comprise close to half of all foreign financial institutions in China.

Along with the state-owned and foreign banks, China’s financial system includes rural and urban credit cooperatives. Rural credit cooperatives are collectively owned financial institutions under the guidance of the Agriculture Bank of China. By the end of 1989, there were almost 60,897 credit cooperative branches and savings offices nationwide. Loans from credit cooperatives totalled RMB 109 billion ($23 billion) as of December 31, 1989.

Nonbank financial institutions expanded rapidly in the late 1980s. A government campaign to "clean-up" the sector has since resulted in a reduction in the number of such institutions and severe limitations on their business activities. Total assets of trust and investment companies were estimated at RMB 70 billion ($15 billion) at year-end 1989.

In China interest rates on local currency loans and deposits are set administratively by the Central Government. In March 1990, interest rates on loans were reduced to provide additional support for the development of "backbone" sectors and 234 key enterprises identified by the Government.

Individuals may not take out loans, but they may leave deposits. With the introduction in 1988 of value-preserving savings deposits, urban personal savings have soared. Despite recent reductions in interest rates, deposits have continued to grow. As of mid-1990, they equaled more than one-third of gross national product.

U.S. Presence in the Market

Ten U.S. banks, two U.S. insurance companies, and one major U.S. credit card company are represented in China. U.S. banks and other financial institutions have opened 17 representative offices in China, most of them in Beijing but also in Shanghai and Guangzhou. U.S. institutions have also invested in joint venture leasing companies, consulting companies and merchant banks.

Wholesale banking and trade finance are the market staples for U.S. banks in China. Primarily through their branches located outside of China, U.S. banks handle letters of credit and funds transfers, arrange or participate in U.S. or other export credit programs, participate in joint ventures in commercial banking and leasing, provide financial advice for major projects, trade currency and bonds with Chinese banks, manage funds for Chinese entities, intermediate the disbursement of loans, underwrite the Government of China's bond issues in international capital markets, and arrange and participate in commercial loan syndications. Representative offices cannot engage in profit-making activities but often help facilitate these activities on behalf of the banks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks, like most domestic financial institutions, are restricted to a specific segment of the lending market. To a limited extent through their branches and otherwise from offices outside of China, foreign banks provide mainly foreign exchange funding for foreign-invested companies. U.S. banks focus heavily on trade finance. They deal primarily with the seven banks and with the major international trusts and investment companies.

Geography: Foreign banks are allowed to open branches in the five special economic zones (SEZs) Shenzhen, Xiamen, Zhuhai, Shantou, and Hainan. Joint venture banks may operate in Shanghai's Pudong development area. (Four non-U.S. foreign bank branches established in Shanghai prior to 1949 were grandfathered.) Elsewhere, foreign banks may only establish representative offices in "open" cities. In contrast, the state-owned domestic banks are not limited geographically and have set up vast, nationwide banking networks.

Scope of Business: With the exception of two experimental banks, foreign bank branches may not accept local currency for deposit. A few designated foreign banks may act as agents for domestic banks and collect local currency deposits, but they may not hold local currency deposits overnight. Although regulations permit foreign banks to make RMB loans, the Government has not included this permission in the charters granted to foreign banks in order to maintain tight control of foreign exchange and interest rates. Foreign banks are excluded, either in practice or by regulation, from other types of business as well. The State Council tends to designate domestic rather than foreign banks to intermediate government project financing. Foreign banks are also restricted to customers who are foreign individuals or foreign-invested companies for most types of transactions.

Taxation and Regulation: While tax treatment of foreign-invested companies, including banks, is much more favorable than that of domestic companies, disclosure and capital requirements are more stringent for foreign banks. There are no nationality restrictions on personnel, including management, although all Chinese employees of representative offices must be hired through the government-owned foreign enterprises service corporation (FESCO). All foreign borrowing must be funnelled through ten "windows" -- the state-owned banks and major international trust and loan companies unless special approval is granted by the PRC Government. U.S. bankers have also been frustrated by China's inadequate financial and investment laws and concerned about the political environment.

China amended its joint venture law in 1990. A banking law and new tax law are apparently in the works. There is, however, no company law clarifying the nature of various entities and whether they enjoy limited liability nor are there well developed laws on financial transactions and mortgages. Moreover, laws are frequently introduced first on a trial basis and not made immediately available to outsiders. An example which affected the representative offices of U.S. banks in China was the adoption in October 1989 of new regulations governing foreign exchange convertibility. The change was not announced and the text of the regulations was not made publicly available.

In virtually each decade of the twentieth century, China's political and economic environment has changed radically. The decade of reform in the 1980s seems now to be shifting to one which emphasizes greater central control and the primacy of politics over economics. U.S. financial institutions with interests in China are finding their decisions influenced by China's austerity program, changes in industrial policy, and the continuing lack of transparency in China's trade and investment regime.

Domestic Securities Market

China's nascent securities market is tiny. A total of RMB 5.0 billion ($1.1 billion) in stocks and bonds was traded between April 1988 (when securities markets were first approved) and the end of 1989; state treasury bonds represented RMB 4.6 billion, or more than 90 percent of the total. Trading takes place over-the-counter, with most deals in cash and positions liquidated immediately. Through 1989, the Central Bank had approved 34 securities companies and the Ministry of Finance had approved 61 securities companies. A total of 400 trust and investment companies have been approved to deal in securities. Stocks can be traded over-the-counter in Shanghai and Shenzhen; there are seven stocks listed in Shanghai, and five in Shenzhen. Turnover on the Shanghai stock market, China's largest, was RMB 7.8 million ($1.7 million) in 1989. Plans to open stock exchanges in Shanghai and Shenzhen and a wheat futures market in Zhengzhou have been announced.

The state-owned People's Insurance Company of China (PICC) has a monopoly on insurance underwriting. Business has boomed as a result of new regulations requiring various types of insurance.

CONCLUSION

There has been slight improvement, but significant denials of national treatment remain. Foreign banks' entry and operations in China are severely restricted. Foreign banks can only open branches in the five special economic zones and the Pudong area. They cannot take local currency deposits or provide local currency loans. Foreign banks may open representative offices in other areas, but they cannot engage in direct profit-making business.

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* U.S. dollar figures calculated at the following rates:

1989: $1 = yuan 3.7061 AA; 4.7221 Year-end
1990: $1 = yuan 4.7339 (June 1, 1990)

29. Indonesia - Banking

SUMMARY

Banking reforms since 1983 have reinvigorated the banking sector in Indonesia. In response to reforms, the number of banks has increased substantially as new domestic banks and foreign joint ventures have entered the market. Existing banks have increased the number of their branches and banking services have become more widely available to the Indonesian population at large.

Discrimination against foreign banking operations has been reduced in recent years. Reforms implemented in October 1988 permitted existing foreign bank branches to establish additional sub-branches in the capital, Jakarta, and several other cities. Other foreign banks are again permitted to establish Indonesian operations; however, they must form joint ventures with existing national banks. Capital requirements for joint venture banks are higher than for domestic banks. Joint venture banks and new sub-branches of existing foreign bank branches must devote 50 percent of their lending to export-related activities. Effective January 1991, banks not subject to this export credit rule must devote 20 percent of their lending to small business.

All domestic banks may now operate throughout Indonesia; foreign banks are permitted to lend to customers anywhere in the country, but are restricted to a physical presence in eight specific cities. In March 1989, Bank Indonesia (the Central Bank) issued regulations stipulating that the net open foreign exchange position of foreign exchange banks and nonbank financial institutions (NBFIs) not exceed 25 percent of bank/NBFI capital. Bank Indonesia is in the process of implementing limits on lending to one borrower defined as a percentage of capital. In April 1991, new capital adequacy requirements announced in October 1988 will be fully implemented. The impact of the capital adequacy requirements may vary between foreign bank branches and domestic banks and joint ventures, because of the different nature of foreign bank branches' capital structure.

There has been significant improvement with movement toward national treatment although some denials remain.

As of year-end 1989, U.S. banks in Indonesia operated five branches with assets of $1.1 billion and four subsidiaries with assets of $118 million. This presence represents a

net increase of $415 million in assets since year-end 1985. At that time U.S. banks in Indonesia operated five branches with assets of $700 million and four subsidiaries with assets of $103 million.

At the end of 1989, seven Indonesian banks operated four agencies with $698 million in assets and four branches with $1.9 billion in assets in the United States. One Indonesian bank maintains a representative office in the United States.

OVERVIEW

Recent Reforms: The Indonesian banking sector has been undergoing substantial reform and remains in a state of flux. In 1983, all credit ceilings were eliminated and deposit rates at state-owned banks decontrolled. Also, in 1983, the Bank Indonesia reduced the scope of its liquidity credit program, a refinancing scheme designed to influence sectoral allocation of bank lending. A wide range of loans, accounting for about 60 percent of outstanding liquidity credits, were made ineligible. In the next two years, a Bank Indonesia money market certificate and commercial paper endorsed by banks and NBFIs were introduced.

In October 1988, the Government of Indonesia introduced a second round of banking deregulation policies. The GOI package *inter alia*:

-- Permitted existing Indonesian banks to open branches throughout the country;

-- Allowed private nationals and cooperatives to establish banks;

-- Eased the rules for a bank to become a foreign exchange bank;

-- Permitted state-owned enterprises to place up to 50 percent of their deposits in banks that are not state-owned, thereby abolishing the requirement that state-owned enterprises place all their deposits in state-owned banks;

-- Reduced the reserve requirement from 15 percent to 2 percent;

-- Raised minimum paid-in capital requirements for private banks;

-- Established bank/NBFI legal lending limits based on capital (20 percent to one borrower and 50 percent to one business group), which became effective October 1990 (certain classes of credits such as government guaranteed credits and syndicated loans may be excluded from the lending limits);

-- Allowed existing foreign-owned bank branches to establish additional sub-branches in Jakarta and to open sub-branches in six other cities (increased to seven in January 1990); and

-- Allowed new foreign entrants to establish joint venture banks with head offices and sub-branches in Jakarta and/or the six (now seven) other locations as above.

Under the reform package, the new sub-branches of existing foreign-owned bank branches and the new joint venture banks were required to extend at least 50 percent of their credits to export-related activities. In October 1989, it was announced that, if a 100 percent foreign-owned bank branch opened a new sub-branch in Jakarta, the bank's entire Jakarta operation, main office included, would be subject to the 50 percent export credit rule.

In March 1989, Bank Indonesia replaced previous ceilings on foreign exchange borrowing with a requirement that an institution's net open foreign exchange position not exceed 25 percent of capital.

In January 1990, the GOI further reduced the number of sectors eligible for Bank Indonesia liquidity credits. Simultaneously, it announced that all banks not subject to the 50 percent export credit rule would be obliged to extend 20 percent of their credit to small business.

The GOI has stated that the basic law on banking is under review to ensure its consistency with banking reforms and modern practices. In addition, the GOI is studying Indonesian commercial law to determine whether legal recourse provisions and implementation are adequate.

Domestic Banking Market

The number of banks has increased rapidly since the reopening of the market in 1988. Existing branch networks have been significantly expanded. As of June 1990, the banking market consisted of the following participants:

- Ten foreign-owned bank branches, including five U.S. bank branches, established in 1968 and 1969;
- One joint venture bank established in 1969 and 11 joint venture banks established with French, Japanese and other partners after October 1988;
- Sixty-six foreign bank representative offices, including several U.S. bank offices;
- Five state-owned commercial banks, one state-owned savings bank, one state-owned development bank, and 27 local government-owned development banks;
- Ninety-five national commercial banks, of which 20 were foreign exchange banks; and
- Thousands of small, rural banks.

As of December 31, 1989, consolidated bank balance sheets were as follow (RP billions; $1 = RP 1,793; Bank Indonesia statistics):

Consolidated Balance Sheet
December 31, 1989
(Billions of Rupiah)

	State-Owned Banks	Private National Banks	Foreign Banks	(of which U.S.)
Assets				
Cash	603	333	23	(10.6)
Due from Bank Indonesia	3,078	1,274	160	(19.2)
Due from Other Banks	2,905	4,411	340	(0.2)
Checks and Other Claims	1	4	N/A	(52.3)
Securities	1,670	2,420	360	(15.8)
Time Deposits			N/A	(1.4)
Loans in Local Currency	40,704	18,992	2,127	(1,056.5)
Foreign Exchange Assets	10,667	4,787	2,150	(1,029.3)
Equity	139	98		
Fixed Assets	573	514	90	(24.3)
Miscellaneous	2,183	1,023	192	(112.0)
Total Assets	62,523	33,856	5,442	(2,321.6)
Liabilities				
Demand Deposits	7,686	4,824	520	(260.7)
Current Liabilities	776	526	74	(88.2)
Savings	2,526	2,681	5	(2.3)
Time Deposits	14,743	11,145	1,085	(564.5)
Funds borrowed	22,859	7,005	935	(289.3)
Guaranteed Deposits	193	69	3	(0.2)
Foreign Currency Liabilities	8,414	4,445	2,022	(1,014.4)
Miscellaneous	2,690	741	161	(59.9)
Capital	52	1,252	506	(1.9)
General Reserves	1,917	722	42	
Other Reserves			N/A	(11.5)
Current Year Profit	667	446	89	(23.5)
Last Year Profit	N/A	N/A	N/A	(5.3)
Total Liabilities	62,523	33,856	5,442	(2,321.6)

Total for System: RP 101,751 billion ($56.7 billion)
$1 = RP 1,793

Percentage of Total	61.5	33.2	5.4	(2.2)

As of December 31, 1989, outstanding bank credits in rupiah and foreign exchange were as follows (excludes interbank credits, credits to central government, and nonresidents and foreign exchange component of project aid) ($1 = RP 1,783):

Outstanding Bank Credits
December 31, 1989
(Billions of Rupiah)

Lender	Rupiah	Foreign Exchange	Total
Bank Indonesia (Direct Credits)	56,756	0	56,756
State Commercial and Development Banks	42,578	2,528	45,106
Regional Development Banks	1,625	0	1,625
Private National Banks	17,193	1,269	18,462
Foreign Banks (including U.S. Banks)	1,839	815	2,654
Total	119,991	4,612	124,603

Source: Bank Indonesia

U.S. Presence in the Market

Two of the ten foreign-owned banks with branches in Indonesia are owned by U.S. banks; all ten were established in 1968 and 1969. Each of the U.S. branches has a sub-branch in Jakarta. One U.S. bank branch and several other foreign bank branches and joint ventures have opened sub-branches in Surabaya, Indonesia's second largest city. The number of U.S. bank representative offices in Indonesia has declined in the past five years as U.S. banks redefined their business strategies. There is renewed interest on the part of some U.S. banks and several have recently opened or applied to open representative offices in Indonesia. U.S. banks have not established new joint venture banks with local partner banks, although they are permitted to do so under the October 1988 banking deregulation package.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Entry and Establishment: Before the October 1988 banking deregulation, foreign bank branches in Indonesia were permitted to establish only one sub-branch, which along with the main branch, had to be in Jakarta. While national banks could lend throughout Indonesia whether or not they had branches in the regions concerned, foreign bank branches were permitted to lend directly only to customers in greater Jakarta except for loans syndicated with local banks and, after September 1985, export credits. Since October 1988, existing foreign bank branches have been permitted to open additional sub-branches in Jakarta and to open sub-branches in Medan, Bandung, Semarang, Surabaya, Denpasar, Ujung Pandang, and, since January 1990, Batam Island.

All new foreign operations must be in the form of joint ventures with local partner banks. New entrants must have an existing representative office to apply for a joint venture license. They must be classified as major banks in their country of origin and be from a country which agrees to a reciprocal arrangement. Paid-in capital must be at least Rp 50 billion ($27.1 million) of which the domestic partner's share must be at least 15 percent. The paid-in capital requirement for a new local commercial bank is Rp 10 billion ($5.4 million).

Foreigners may not purchase stock in Indonesian banks under the Basic Law on Banking; however, the Government of Indonesia has announced that the Basic Law on Banking is under review.

Operations: Since October 1988, foreign bank branches have been permitted to lend to customers anywhere in Indonesia. Foreign banks and domestic banks can conduct the same kinds of banking operations. In addition, all foreign banks and some state-owned and private national banks are designated as "Foreign Exchange Banks," i.e., permitted to undertake transactions in foreign exchange. In March 1989, Bank Indonesia set a requirement that a bank's net open foreign exchange position could not exceed 25 percent of its own capital.

Limits on lending to one company/individual (20 percent of capital) and one group of companies (50 percent of capital) take effect in October 1990. In April 1991, the capital adequacy requirements announced in October 1988 will be fully effective. The definition of capital will become important not only for defining a bank's net open foreign exchange position, but also for its general lending and equity participation in financial and nonfinancial institutions. The net open foreign exchange position rules affect all foreign exchange banks and NBFIs. The legal lending limits will affect all banks and NBFIs, but capital will be defined differently for foreign bank branches than for other types of banks. A net head office funds formula has been adopted as the measure of capital for foreign bank branches.

Domestic Securities Markets

Following a period of stagnation, Indonesia's capital market revived in 1988 and 1989. This was due to a variety of factors including:

-- The imposition of a 15 percent tax on interest income from bank deposits that narrowed the tax bias against equity finance;

-- The establishment of over-the-counter trading to enable smaller enterprises to participate in the market;

-- Authorization of private sector operation of stock exchanges in Jakarta and other major cities;

-- Permission granted to banks and nonbank financial institutions to raise capital in the stock market; and

-- The lifting of the ceiling of 4 percent on the daily movement of share prices in the stock exchange.

Foreign investors are allowed to acquire up to 49 percent of the shares of companies listed in the stock exchange, except those of Indonesian banks (a restriction which is under review by the GOI). Capital gains for foreign investors are exempt from taxation. Foreign holdings increased from practically zero to an estimated 30 percent of the market by end-1989.

Regulations issued in December 1988 permitted the operation of foreign joint venture securities houses and allowed them to act as stockbrokers, traders and underwriters. Initial capitalization was set at Rp 8 billion ($4.4 million) versus Rp 2 billion ($1.1 million) for Indonesian-owned securities houses. Several foreign securities firms have established joint venture offices in Jakarta.

In 1989, the value of new equity share and bond issues totaled Rp 3.8 billion ($2.1 million) and Rp 0.6 billion ($339,000), respectively. This represented a sharp increase in the number of new issues (a combined total of 66 for shares and bonds, compared with 12 in 1988). The majority of the new issues were vastly oversubscribed. The Government intends to privatize the Jakarta Stock Exchange (JSE). Such a move should enhance the attractiveness of the stock exchange and further promote its use as a source of equity and long-term finance. The Indonesian Stock Exchange Executive Agency, which operates the JSE, is expected to concentrate on its role of supervising the market.

The Government is also considering stricter regulations of the capital market. These would strengthen the transfer payment and settlement systems, and improve disclosure requirements by companies and intermediaries participating in the market. In addition, the Government is considering measures which would define insider trading, establish guidelines for supervisory obligations and provide for domestic investment trusts and corporate convertible bonds. They would also establish upper limits on subscription and allotment periods.

CONCLUSION

There has been significant improvement with movement toward national treatment although some denials remain. Recent reforms in the banking sector permit existing foreign bank branches to expand and new foreign entrants to establish branches, provided they form joint ventures with existing national banks. While restrictions remain on capital requirements and some lending activities, foreign banks can conduct the same banking operations as domestic banks and lend to customers throughout Indonesia. In addition, in Indonesian securities markets, recent reforms in the stock exchange and bond markets have permitted the establishment of foreign joint venture securities houses which can act as stock brokers, traders and underwriters.

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*U.S. dollar figures calculated at the following rate:

1$ = R 1,844.0 (end of June 1990)

30. Norway - Banking

SUMMARY

Deregulation of the Norwegian financial sector, begun in the early 1980s, has resulted in a less restricted market with increased opportunities for foreign banks. Although the initial opening to foreign banks in 1985-86 was disappointing, new proposals would improve treatment of U.S. banks, subject to Norway's reciprocity requirement.

Substantial changes in Norwegian regulations governing foreign banks were announced in February 1990, some of which were subsequently approved by the Parliament. As a result, foreign banks from countries which grant reciprocal rights to Norwegian banks may now acquire Norwegian financial institutions, and Norwegian bank subsidiaries of foreign banks may now establish branches in Norway, provided depositor funds are sufficiently protected. Both require the permission of the authorities. Moreover, the Government of Norway is considering a proposal to allow banks incorporated outside the country to establish branches in Norway. These provisions should result in a major improvement in the treatment of foreign banks.

Thus, there has been significant improvement toward full national treatment although some restrictions remain.

As of year-end 1989, three U.S. banks in Norway (Citibank, Chase Manhattan, and Manufacturers Hanover) operated three subsidiaries with assets of $294 million. This represents an increase of $95 million in assets since year-end 1985. Six other foreign banks are also present.

At the end of 1989, Norwegian banks in the U.S. operated four branches with assets of $690.6 million. Norwegian banks or individuals controlled four New York State investment corporations with assets of $409 million. Norwegian banks maintain nine representative offices in the United States. This presence is a significant increase in branches and assets since year-end 1985. At that time, each of the three largest Norwegian banks owned New York State investment companies (in whole or in part) and maintained five representative offices in the United States. Two were in the process of opening branches in the United States.

OVERVIEW

Domestic Banking Market

Deregulation of the banking sector, initially undertaken in the early 1980s, accelerated between 1986 and the present.

Wide ranging proposals announced in February 1990 would continue this process. Liberalization measures undertaken to date allow banks to set their own interest rates (previously set by the Government), issue certificates of deposit and short-term and medium-term commercial paper, set up branch offices and invest up to 4 percent of their assets in the stock market.

The changing composition of the Norwegian credit market reflects liberalization and growth in the private sector. In September 1989, the ten government-owned banks and the postal savings bank accounted for less than one-fifth of loans outstanding in Norway, compared to about one-third in 1985. Privately owned depository institutions, which include 21 domestic commercial banks, eight foreign commercial banks, and the 149 domestic savings banks, have a network of 1,694 branches and account for about 50 percent of loans. The growth of the private sector is expected to continue to outstrip that of public credit institutions in coming years. The Norwegian credit market also includes 13 life insurance companies, seven other insurance companies, 55 finance companies, and 13 bond-issuing credit associations. The following table displays market shares of the various types of institutions which participate in the market.

Norwegian Credit Market
October 1, 1989

Type of Institution	Institutions (number)	Distribution of Assets (percent)	Distribution of Loans (percent)
Postal Savings	1	5.3	.9
State Banks	10	13.3	18.8
Commercial Banks	21	28.7	29.9
Commercial Banks (foreign, non-U.S.)	5	.5	.3
Commercial Banks (U.S.)	3	.2	.2
Savings Banks	149	20.2	21.7
Credit Associations	13	13.8	16.8
Finance Companies	55	3.6	4.2
Insurance Companies (1)	20	14.4	7.2
Total	277	100.0	100.0

Source: Bank of Norway

(1) Includes 11 life insurance companies and the largest non-life insurance companies.

Deregulation, concern for competitiveness in an increasingly integrated European financial market and a deep recession have resulted in a number of mergers among Norwegian banks in recent months. Two of the three largest commercial banks merged in April 1990 to form the largest bank in Norway with assets of approximately 209.6 billion kroner ($32 billion at an average April 1990 exchange rate of $1 = kroner 6.5506). The largest savings bank in Norway has announced plans to merge with four other savings banks. The trend toward consolidation is expected to continue and is seen by regulators (who must give their consent for bank mergers) as a necessary part of the process of adjustment to the European Community's 1992 single market in financial services.

U.S. Presence in the Market

Norway was closed to foreign banks until 1985-86 when nine foreign banks (including Citibank, Chase Manhattan, and Manufacturers Hanover from the United States) were allowed to establish wholly owned subsidiaries. Most of the foreign banks in Norway are niche players, concentrating on international trade and other fields in which their particular expertise is most valuable. The exceptions have been the Swedish banks, which see greater opportunities to extend their retail operations into Norway. The small size and traditional nature of the market will probably continue to discourage banks from other countries from attempting to compete with the Norwegian banks in the wider market.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Entry and Establishment: Before 1987, foreign banks were limited to the establishment of wholly owned subsidiaries as a means to enter the Norwegian market. Although the Norwegian Government indicated that, except for an initial prohibition against branching, the foreign banks' subsidiaries would receive treatment equal to that afforded Norwegian banks, substantial inequality in treatment was in fact maintained. Foreign banks experienced difficulties in investing in finance companies, and were denied permission to open affiliated offices, issue subordinated debt capital, or trade securities. Some banks which intended to provide a wide range of services found themselves paring back operations substantially when the conservative nature of the market and the limiting effects of remaining government restrictions became apparent. While not a denial of national treatment, the requirement that establishment be in the form of a subsidiary posed difficulties for foreign banks.

Most importantly, Norwegian regulations which limit the maximum size of loans an institution may provide to a fixed percentage of its equity capital severely restricted the size of loans which the subsidiaries could make to their customers. This particularly affected the large U.S. banks, which were specifically interested in large "wholesale" transactions rather than retail accounts.

In 1990, two Norwegian subsidiaries of foreign banks were given permission from the Ministry of Finance (MOF) to acquire Norwegian banks. The MOF submitted a proposal to Parliament in February 1990, to allow foreign banks to establish branches and acquire Norwegian financial institutions. Acquisitions would be subject to Ministry approval and, when deciding applications, the MOF would weigh both reciprocity issues and the desire to maintain Norwegian control over the largest Norwegian institutions.

The report submitted to Parliament by the Ministry declared a willingness to explore the means necessary to permit establishment while ensuring that Norwegian depositors would be protected from possible losses.

Short of direct acquisition, however, foreign ownership of voting shares in Norwegian financial institutions is limited to 33 1/3 percent, the same percentage which applies for Norwegian industry.

Operations: Deregulation of the Norwegian banking sector is also improving the treatment of foreign banks operating in Norway. One early limitation on the ability of foreign banks to operate in Norwegian financial markets was the denial of licenses necessary for securities trading. Subsidiaries of foreign banks are now allowed to participate in the securities market on even footing with Norwegian banks.

Foreign bank subsidiaries were also denied national treatment in branch banking. Foreign bank subsidiaries were not allowed to establish branch offices until 1989. In the February 1990 report to Parliament, the MOF announced that subsidiaries of foreign banks operating in Norway would now be allowed to open branches under the same conditions as Norwegian banks. Since then, two Swedish bank subsidiaries have opened branches.

The issuance of subordinated debt is an important means for financing banking operations in Norway. On December 1, 1988 subordinated debt accounted for 3.7 percent of the total assets of domestic Norwegian banks -- more than four times the value of share capital. Although foreign bank subsidiaries were not allowed to issue subordinated debt instruments in the past, they have been authorized to do so since 1987.

Domestic Securities Market

There are 55 finance companies and 13 bond-issuing credit associations, along with 20 (13 life and seven non-life) insurance companies in Norway. Finance companies and credit associations combined hold 17.4 percent of total assets in the financial system, and insurance companies hold the remaining 14.4 percent of assets not held by banks.

No wholly foreign owned firms are members of the relatively small Oslo Stock Exchange or the even smaller exchanges in Bergen and Trondheim, although three member firms are partially foreign owned. Foreign firms have been permitted membership since 1986; however, and at least one (Citibank) was a member of the exchange in the past. No special regulations govern securities trading by foreigners, but foreign ownership of Norwegian concerns is limited under Norwegian law. In most cases, foreigners can own no more than 33 1/3 percent of the voting shares of a Norwegian company.

CONCLUSION

Significant improvement toward full national treatment has been made although some restrictions remain. After initial deregulatory moves in the mid-1980s permitting entry of foreign banks as subsidiaries, regulatory changes in February 1990 are expected to open the banking sector by allowing Norwegian subsidiaries of foreign banks to open branches and foreign banks to enter the market through establishment of branches (if authorities are satisfied with depositor protection). Moreover, the Government of Norway is considering permitting the purchase of local financial institutions by foreign banks from countries that grant this right to Norwegian banks. Also, subsidiaries of foreign banks have been granted securities trading licenses, which enable them to compete on an even footing with the local banks.

31. Philippines - Banking

SUMMARY

The Philippine banking system remains restrictive and inefficient. The system is dominated by 29 commercial banks. Four of these commercial banks are foreign bank branches; two are branches of U.S. banks, grandfathered from colonial times. They do not receive national treatment. Foreign banks are now limited to 40 percent equity in existing domestic banks. Despite these restrictions, foreign banks control 23 percent of the banking system's assets and U.S. banks alone account for 16 percent.

Banks with 40 percent or less foreign equity receive national treatment. However, the foreign bank branches are prohibited from establishing additional branches and from offering trust accounts, except for Hongkong and Shanghai Bank which has had a trust license since the 1930s. A prohibition against the installation of automated teller machines outside the premises of a bank was lifted in June 1990. The Government of the Philippines (GOP) is reportedly considering a package of banking reforms which would, among other things, liberalize the establishment of branches and lower intermediation costs by phasing out the gross receipts tax on bank operations. U.S. banks form about half of the total of 46 representative offices and offshore banking units (OBUs) now active in Manila.

Significant denials of national treatment, especially with respect to entry, remain with no improvement.

As of year-end 1989, U.S. banks in the Philippines operated 13 branches with assets of $2 billion and four subsidiaries with assets of $727 million. This presence represents an increase of $692 million in assets since year-end 1985. At that time, Bank of America operated one branch and Citibank three, with assets of $615 million and $1.42 billion, respectively. Eleven of the 24 offshore banking units were from the United States. Eight U.S. banks had minority interests in five commercial banks and four finance companies. Five other U.S. banks maintained representative offices.

At the end of 1989, six Philippine banks operated two agencies with assets of $29 million, five branches with assets of $239 million, and three subsidiaries with assets of $204.5 million in the United States. Philippine banks maintain two representative offices in the United States. This presence represents an increase of one branch and assets of $182 million since March 1986. At that time, six Philippine banks operated six branches, three subsidiaries, two agencies, and three representative offices in the United States with total assets of $291 million.

OVERVIEW

Domestic Banking Market

The Philippine banking system remains underdeveloped with a deposit base of only 18 percent of gross domestic product (GDP). Characterized by small and inefficient banks, high intermediation costs and high profits, it is dominated by the 29 commercial banks. Six of the largest commercial banks are universal banks, allowed to engage in equity financing.

Total Assets of Banking System, 1989

	Number	Peso Millions
Commercial Banks	29	394,366
(Wholly foreign-owned)	(4)	(41,829)
(Wholly U.S.-owned)	(2)	(31,516)
Thrift Banks	106	32,204
Rural Banks	824	12,160
Specialized Government	3	26,734
Total	962	465,464

Source: Central Bank of the Philippines

Commercial banks in the Philippines provide commercial banking, trust and investment banking services. Consumer credit cards and automated teller machines are increasingly available.

Philippine banking dates from the colonial era and several of the current commercial banks are direct descendants of Spanish and American banks. The first Filipino bank, the Bank of the Philippine Islands, was established in 1851. From 1950 to 1972, banking expanded rapidly and 27 new commercial banks were created, most of which were dominated by wealthy families. Since 1972, new banking licenses have generally been denied, and the sector has been tightly regulated by the Central Bank.

From 1972 to 1980, the Government heavily intervened in financial markets, setting interest rates low, with preferential rates for favored industries and projects. Used as a channel for political favoritism, the banking system was not an efficient allocator of capital. These imprudent lending policies helped precipitate the collapse of several banks in the early 1980s.

Beginning in 1981, the Government lifted caps on lending and deposit rates and took several steps to restore competition and efficiency. However, it also levied taxes on bank receipts and maintained the ban on new banks, undercutting the liberalizing reforms. Competition remained restricted by the Government's reluctance to license new branches.

The banking system caters to established, blue chip borrowers and invests heavily in government instruments. Lending terms are short, generally under two years. The lack of effective competition combined with government taxation policies has created a profitable environment for banking.

U.S Presence in the Market

Two of the 29 commercial banks are 100 percent U.S.-owned branches (Citibank ranks fourth and Bank of America fifteenth in assets). The other two smaller foreign-owned commercial banks, Hongkong and Shanghai Bank and Standard and Chartered, were established during the colonial era like their U.S. counterparts. These foreign branches operate as full retail and commercial banks (with the exceptions noted above). Six other commercial banks have substantial U.S. ownership (generally 40 percent of equity). There is no foreign investment in thrift or rural banks, and no indication of interest by foreign investors. However, the Aquino Administration has recently announced plans to allow foreign purchases of up to 30 percent shares in rural banks.

Foreign Presence in Commercial Banking System, 1988

	$ Millions	Percent
Total Assets:	18,749	100
Wholly Foreign-Owned	2,192	12
Wholly U.S.-Owned	(1,665)	(9)
Foreign Share of Joint Banks	2,091	11
U.S. Share of Joint Banks	(1,420)	(8)
Total Foreign Share	4,283	23
Total U.S. Share	(3,085)	(16)

Currently, there are 46 foreign banks with representative offices and/or offshore banking units in Manila. These are generally limited to soliciting business for parent banks and/or trade financing. Twenty of these offices are U.S. owned.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Since 1948, establishment of new wholly owned foreign banks has been prohibited in the Philippines. The four existing foreign bank branches were allowed to retain 100 percent ownership by incorporating their branches under Philippine law. The same law also limited foreign ownership in Philippine banks to 30 percent. Forty percent equity is possible with Presidential authorization, which has generally been attainable.

There was a general ban on establishment of new domestic commercial banks from 1972 until February 1990, when the first new commercial bank license was issued. Foreign banks wishing to invest in the Philippines have been limited to purchases of up to 40 percent of voting stock in existing domestic banks. In practice, this has meant buying into institutions with troubled portfolios, which are the only ones up for sale. However, a number of foreign banks, including six U.S. banks, have found the proposition attractive enough to proceed.

The wholly owned foreign banks have not been allowed to engage in universal banking business, though there is no explicit regulation to that effect. With the exception of Hongkong and Shanghai Bank, which was grandfathered, foreign banks are also not allowed to engage in trust activities. This is significant because GOP taxes and regulations have driven many domestic banks to handling their larger long-term accounts through trusts. In 1989, trusts comprised from 25 and 36 percent of domestic commercial banks' business.

Perhaps the most serious restriction is the GOP's refusal to allow the four foreign banks already in the Philippines to establish additional branches, particularly outside Manila. The GOP has also been restrictive in licensing new branches for domestic banks, including those with foreign equity, although there have been several major exceptions. The prohibition on branching also barred automated teller machines (ATM) for foreign banks outside bank premises; however, the Central Bank of the Philippines lifted the prohibition on the installation of ATMs outside bank premises in June 1990. At this time, foreign banks had not had an opportunity to test this new policy.

Regulations permitting offshore banking units were adopted in 1976. Twenty-two units were eventually set up in the Philippines. However, regulations have been gradually tightened since that time, including prohibition of renewing medium-term loans as they fall due and restraint of permitted letter of credit guarantees. A number of the offshore banking units have been forced to cut back their operations. However, the majority have done fairly well by concentrating on trade finance.

Domestic Securities Market

Many Philippine corporations remain family-owned or closely held by small groups of investors. Due to high interest rates as well as traditional practice, much corporate activity is internally financed. Consequently, Philippine securities markets are small and underdeveloped. Trading in corporate equity, corporate debt and government securities is allowed on the country's two stock markets in Manila and Makati. While the markets have grown rapidly during the past three years, they remain small compared to other Asian securities markets. In 1989, the market capitalization of stocks of 151 companies traded on the exchanges totalled $12 billion. The market for private corporate debt is small and not active. Trading in government securities (mostly in the form of Treasury bills) is limited to a fairly small group of banks, insurance companies and governmental financial institutions.

U.S. financial institutions in Manila are generally not active participants in Philippine securities markets. Citicorp/Vickers and Bankers Trust Securities hold seats on the Makati Stock Exchange. Foreign financial institutions are allowed to trade through the securities markets, although they are not permitted to borrow pesos in order to cover clearing costs.

CONCLUSION

Significant denials of national treatment, especially with regard to entry, remain with no improvement. Foreign bank entry into the Philippines remains limited to minority participation in domestic financial institutions and offshore banking units, and to representative offices in Manila. U.S. banks that were established before restrictions were introduced on new entries account for about one-sixth of the commercial banking market; they are, however, prohibited from opening new branches and offering trust accounts. Whether they will be able to establish automated teller machines off their premises remains to be seen.

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*U.S. dollar figures calculated at the following rate:

1989: $1= pesos 22.33 YE

YE = Year-End

32. Sweden - Banking

SUMMARY

Prior to 1986, foreign entry into Sweden's financial markets had been severely restricted by currency controls initially imposed during World War II. Their gradual relaxation has allowed foreign participation in Sweden's financial markets to expand. While vestiges of the currency control remain, they are continually being reduced.

Foreign banks may now enter the Swedish market by establishing branches or subsidiaries and/or by acquiring partial ownership in Swedish banks. While establishment of subsidiaries has been permitted since 1986, establishment of branches and acquisition of shares in Swedish banks were only permitted recently as a result of an amendment to the banking law, effective August 1, 1990. The amendment significantly liberalizes Sweden's policies regarding foreign bank entry, bringing them closer to practices in the European Community.

As Swedish legal entities, subsidiaries receive national treatment. Branches of foreign banks will be able to tap the resources of their parent banks. The Central Bank plans to adjust its lending guidelines by the end of 1990 to accommodate foreign bank branches in a non-discriminatory manner. The new regime has not been in effect long enough to determine whether there will be any _de facto_ restrictions on the operations of foreign bank branches.

There has been important movement toward full national treatment as meaningful improvement continues.

At year-end 1989, two U.S. banks in Sweden operated subsidiaries with assets of $739 million. Sweden opened its financial markets to foreign banks for the first time in 1986, at which time, two U.S. banks were approved and established subsidiaries. Two other U.S. banks maintained representative offices.

At the end of 1989, three Swedish banks operated two branches with assets of $1,587 million and two New York State investment companies with assets of $1.1 billion in the United States. Swedish banks maintain five representative offices in the United States. This presence represents an increase of $1.5 billion in assets since March 31, 1986. At that time, Swedish banking operations in the United States consisted of one agency, two New York State investment companies and one Edge Act corporation, with assets totaling $1.1 billion. An additional two Swedish banks maintained a total of four representative offices in the United States.

OVERVIEW

Domestic Banking Market

The Swedish money and bond markets enjoyed rapid growth during the 1980s. A number of new instruments have been introduced in Sweden since March 1980, when the first money market instrument - a certificate of deposit - was issued. During the 1980s, Sweden's monetary policy underwent fundamental changes, moving from a heavy dependence on price and quantity regulations to a more market-oriented approach. The 1980s have also been characterized by deregulation and innovation, and a rapid market expansion in terms of volume of turnover, number of instruments and number of participants. This development went virtually unnoticed in the rest of the world, due to stringent currency regulations which prevented foreign investors and borrowers from participating, while Swedish investors were not allowed to make portfolio investments in foreign markets. By mid-1989, however, the Swedish Government abolished most of the remaining currency regulations, opening up opportunities for foreign investors to acquire Swedish money market instruments and bonds.

Overnight Market: The Swedish money market has for some years had an overnight loan market. Overnight loans may take the form of direct transactions between participants in the market or of sales of securities containing a repurchase agreement effective the following banking day. This overnight market is one in which the banks primarily trade the liquidity which arises from their daily operations. Overnight loans are generally made in amounts of Swedish kronor (SEK) 100 million ($16.4 million)*. Deficits can be met through borrowing from the Central Bank. In recent years, a number of financial institutions have begun to utilize the overnight loan market on a regular basis for their short-term financing. Commercial firms and other institutions often use the overnight loan market for short-term investment of their temporary cash surplus.

Short-term Instruments: In addition to Treasury bills, there are other short-term instruments such as commercial paper. Corporations, finance firms and banks are the principal issuers. Maturities typically range from 30 to 360 days. Credit risks in the Swedish market are considered to be low. The relatively small number of borrowers makes it easier for a Swedish investor to stay informed about the borrower's creditworthiness.

Bond Market Structure and Features: Government bond trading in Sweden is conducted between banks and brokers over the telephone. Unlike the practice in foreign bond markets, Swedish bond prices are quoted on a yield basis rather than on a cash price basis. Like most other countries, Sweden issues government bonds through auctions where the primary dealers can place their bids.

Commercial Banks: Commercial banking in Sweden is dominated by three large Swedish banks: Nordbanken, Skandinaviska Enskilda (S-E) Banken, and Svenska Handelsbanken. Late in 1989, the former PKbanken (about 70 percent government-owned) merged with the provincial bank, Nordbanken. Although medium sized in assets, Nordbanken had 100 branches, scattered primarily over Sweden's vast northern provinces. The new bank retained the name Nordbanken. In terms of assets, it is now Sweden's largest bank.

Savings Banks: Swedish savings banks are similar to mutual savings banks chartered by some states in the U.S. Half of their directors are appointed by the municipalities in which they operate. The remainder are elected from among the bank's depositors. Unlike commercial banks, the savings banks issue no stock and have no shareholders. Funds are derived from both deposits of members and retained earnings.

Sweden presently has more than 100 savings banks of varying size. The 10 largest account for about 73 percent of the total assets of all savings banks. Swedbank (Sparbankernas Bank) is a commercial bank which handles foreign business and securities transactions for most of the savings banks.

Cooperative Banks: The cooperative banking system presently has 391 local cooperative banks, which are organized under 12 regional cooperative banks. These in turn belong to the National Federation of Swedish Cooperative Banks. The local and regional cooperative banks are cooperative associations financed by deposits of members and the general public. No publicly traded shares are issued. Ownership is shared among cooperative members, in proportion to the size of their accounts. Membership in a local cooperative bank is, in principle, open to anyone, while regional cooperative banks accept as members only local cooperative banks and legal entities within their field of operations. Although cooperative banks accept deposits from anyone, only members may borrow from them. The FB Bank (Foreningsbankernas Bank), which is a commercial bank, handles the cooperative banks' specialized financial services. It provides investment services, and manages the liquidity reserves of the local cooperative banks.

Finance Companies: In 1988, a new Finance Companies Act was signed into law. Under the Act, all finance companies are required to register with and receive authorization from the Banking Inspection Board as of July 1, 1989. Special legislation mandates nonbank financial institutions that inter alia provide consumer credit, real estate financing and business financing, including leasing. Finance companies whose aggregate credits to the business sector do not exceed SEK 50 million ($8.2 million) are excluded.

During the early 1980s, finance companies expanded sharply. Loan volumes, however, declined during the latter part of the decade, partly as a result of stricter consumer credit regulations. At the end of 1988, there were about 290 finance companies, with outstanding credits of approximately SEK 121.1 billion ($18.8 billion). Following implementation of the July 1989 legislation, however, a number of finance companies disappeared from the scene, leaving a total of about 183.

Total Assets of All Swedish Banks
($ Million)

		1989	1988
Total assets		179,244.7	150,662.0
of which:	in foreign currencies	71,420.8	49,368.4
	Swedish kronor	107,823.9	101,293.6

Swedish-Owned Commercial Banks - Assets and Equity
December 31, 1988
($ Million)

	Assets	Equity
Skandinaviska Enskilda B.	35,608.5	748.5
PK Banken*	33,093.3	570.0
Svenska Handelsbanken	31,841.1	462.0
Sparbankernas Bank	14,041.1	197.1
Gotabanken	8,846.8	198.0
Nordbanken*	7,555.5	132.8
Skanska Banken	4,019.1	46.7
Wermlandsbanken	2,860.1	39.0
Ostgota Enskilda B.	2,484.0	38.9
Foreningsbankernas B.	2,480.3	68.5
Skaraborgsbanken	2,224.6	36.4
Bohusbanken	361.0	6.9
Jamtlands Folkbank+	349.9	7.3
Sveabanken	149.1	8.0
Total	145,914.4	2,560.1

* Since merged under the name Nordbanken
+ Since merged with PM Capital Markets under the name JP Bank.

Foreign-Owned Banks-Assets and Equity
December 31, 1988
($ Million)

Bank	Assets	Equity
Manufacturers Hanover Bank Sweden	593.8	8.6
Citibank, AB	216.8	12.9
Den Norske Creditbank Sweden	1,022.5	12.2
Bank Societe Generale	763.2	16.3
Banque Indosuez Sweden AB	603.9	10.8
Algemene Bank Nederland (Sweden)	418.1	11.9
Credit Lyonnais Bank Sweden	393.2	16.2
Christiania Bank AB	349.7	16.8
Okobank Sverige	268.9	11.3
Total	4,630.1	117.0

Savings Banks-Assets and Equity
December 31, 1988
($ Million)

10 Largest Savings Banks

Bank	Assets	Equity
Forsta Sparbanken	6,237.4	121.9
Sparbanken Alfa	5,105.0	86.9
Nya Sparbanken	2,842.1	53.9
Sparbanken Skane	2,666.1	36.5
Sparbanken Kronan	2,357.1	47.8
Sparbanken Norrland	1,262.0	21.4
Sparbanken Vast	892.2	14.8
Sparbanken Dalarna	886.3	12.1
Upsala Sparbank	854.0	12.7
Boras Sparbank	723.5	11.4
Total	23,829.5	418.8
All Savings Banks	32,784.8	588.1

Cooperative Banks-Assets and Equity
December 31, 1988
($ Million)

Bank	Assets	Equity
Western Sweden	1,256.9	36.2
Southern Sweden	1,184.2	24.3
Eastern Sweden	777.3	12.4
Malar Provinces	666.4	16.8
Central Sweden	658.1	15.2
Halland Province	611.1	11.7
Central Norrland	591.2	12.6
Gavle Dala	561.7	12.0
Malmoe Province	531.0	9.0
Vasterbotten Province	417.5	10.4
Norrbotten Province	328.1	9.1
Gotland Province	124.1	3.1
All Cooperative Banks	7,707.6	172.8

Finance Companies
Outstanding Credits and Equity Capital
December 31, 1988
($ Million)

Company	Assets and Leasing Equip	Equity
Finans Skandic AB	1,856.0	50.4
Independent Finans AB	1,735.7	110.6
Svenska Finans AB	1,536.0	43.0
AB Probo	731.6	63.6
Pkfinans AB	1,012.2	25.2
Finans AB Nyckeln	1,064.9	13.5
Gota Finans	634.4	44.0
Industri Finans AB	634.4	14.7
Skandinavien Finans AB	555.8	28.9
Telefinans AB	535.4	15.2
Total	10,296.4	409.1

Foreign-owned Banks in Sweden: Twelve foreign-owned commercial banks commenced operations as Swedish subsidiaries in 1986. Of those, ten remained at the end of 1989 and held, at that time, approximately 2 percent of total commercial bank assets.

Since 1974, foreign banks have been permitted to establish representative offices in Sweden. (Since August 1990, government approval is no longer required.) At the end of 1989, there were 37 representative offices registered in Sweden. A representative office may not take deposits or engage in domestic lending, and is only allowed to act as an intermediary in transactions between a Swedish customer and the bank's foreign parent.

U.S. Presence in the Market

Three American banks are represented in Sweden: Citibank AB, which is a Swedish subsidiary that functions primarily as a wholesale bank and intermediary between customers and its parent bank and branches; Manufacturers Hanover, which has been a subsidiary but is scaling down its operations to a representative office in late 1990 or early 1991; and Chase Manhattan, which has had a representative office throughout its tenure in Sweden.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks have been allowed to establish subsidiaries in Sweden since 1986, and as Swedish legal entities have received national treatment. The Swedish Parliament recently approved an amendment to the banking law to permit foreign banks to enter by establishing branches and/or by acquiring partial ownership in Swedish banks. The amendment significantly liberalizes the rules for foreign bank entry into Sweden.

The new law brings foreign banks' subsidiaries and branches under the Law on Foreign Ownership of Corporations and amends that law. As a transitional measure, restrictions on foreign ownership of Swedish corporations will remain in force until such time as the company stockholders decide that all company shares or a portion thereof will be converted to free shares. Such a decision would require government approval. The preliminary means test preceding granting of a bank license will be abolished. From August 1, 1990, the criteria for the award of a banking license focuses on the bank's organization, ownership, capital and management. A license is to be granted if planned operations are expected to meet general banking standards.

Under the new law, branches of foreign banks will be able to tap the resources of their parent banks and will be allowed to borrow from the Central Bank. Operational rules, such as limits on borrowing from the Central Bank, are being devised. While the authorities intend for the rules to be non-discriminatory, it is not yet certain that foreign bank branches will be given full *de facto* national treatment in operations.

Regulation Governing Foreign Investment: Foreign investment is largely regulated by the Law on Foreign Acquisitions of Swedish Firms, which went into effect in January 1983. A foreign company or citizen requires official sanction to establish or operate a business in Sweden. Certain other restrictions apply to aliens with regard to the formation of a corporation, but most of them can be overcome with official concurrence and none presents a serious barrier to the establishment and operation of a bank subsidiary in Sweden.

Regulatory Authorities: The activities of banks and other credit institutions are primarily supervised by the Bank Inspection Board. Other supervisory functions are carried out by the Central Bank (Riksbank), the Swedish AntiTrust Ombudsman, the National Board of Consumer Policies, and the Data Inspection Board.

The Riksbank, which operates under the direct authority of Parliament, acts as banker to the Swedish Government and to the commercial banks. The Swedish Government maintains an overdraft facility with the Riksbank. The Riksbank is responsible for clearing between commercial banks as well as accepting deposits from the banks and for making loans available to them.

The Bank Inspection Board exerts control over a number of credit institutions such as finance companies, stockbrokers, unit trusts, the Stockholm Stock Exchange, the Securities Register Center (VPC), and the Credit Information Center (UC). Special auditors perform actual supervision of bank lending and foreign business.

Foreign Exchange Controls: Over the years, the effectiveness of foreign exchange controls has declined. As a result, they have been all but abolished. The most important reason behind this move is the adjustment to policies of the European Community (EC), whose single internal market will feature free capital movements. Sweden pursues a policy favoring regulations conforming as closely as possible to those of the EC.

Most of the deregulation took place during the middle and latter part of the 1980s. The requirement that Swedish direct investments abroad had to be financed through foreign currency loans was abolished and the maximum amounts of currency allowed for travel and purchases of dwellings abroad were drastically increased. Opportunities for banks to participate in foreign financing operations were also introduced. As of January 1, 1989, restrictions on the following transactions no longer applied:

-- Swedish purchases of foreign shares (they must, however, be deposited with a bank or stockbroker);

-- Sales of Swedish shares abroad;

-- Purchases by legal entities of real estate abroad; and

-- Direct, transborder investment.

As of July 1, 1989, most remaining exchange regulations were, for all practical purposes, removed. Chiefly for bookkeeping purposes, however, the following restrictions still apply:

-- Transborder payments must be made through an authorized Swedish bank;

-- Securities transactions abroad must be effected through an authorized Swedish bank or stockbroker approved by the Riksbank; and

-- Foreign securities must be kept in a safe custody account with an authorized Swedish bank or stockbroker.

Securities Market: The Stockholm Stock Exchange (SSE) is an official institution, operating under specific legislation and pursuant to a special ordinance. Its ability to compete with foreign exchanges that trade in Swedish securities is limited by a 2 percent transaction tax, which makes it cheaper for a resident of Sweden to trade Swedish securities on, for example, the London Stock Exchange rather than the Stockholm Stock Exchange.

At year-end 1988, the SSE had 30 members, 16 of which were securities broker firms and 14 were banks. The number of listed, publicly traded companies was 151. Total turnover in registered stocks was SEK 121.1 billion ($18.8 billion). Of the 151 companies, the 114 largest are on the A:1 list. Seventy-five companies are currently on the over-the-counter list.

The Stockholm securities market is the largest in Scandinavia and now ranks as the ninth largest in the world. As of December 1989, the market capitalization was SEK 718.4 billion ($117.2 billion). Trading volume in 1989 reached SEK 112.8 billion ($18.4 billion).

The stocks of two foreign companies began trading on the SSE in 1988. The instruments traded are so-called Swedish depository receipts. With the introduction of French Saint-Gobain S.A. and Compagnie Generale D'Electricite, there are now nine international companies listed on the SSE: three Finnish, two French, two Norwegian, and one each U.S. and Danish.

Approximately 1,600 bond and debenture loans are also listed on the SSE. The most important issuers are the Central Government, local governments, mortgage institutions, utilities and industrial borrowers.

CONCLUSION

There has been important movement toward full national treatment as meaningful improvement continues. Foreign participation in Sweden's financial markets has been permitted since 1986. Following an official government report recommending extensive liberalization of Sweden's banking law (in the context of the European Community's Second Banking Directive), legislation was passed to effect these changes, including the opening of foreign bank branches. This law took effect in August 1990. In addition, by mid-1989 most remaining foreign exchange controls (dating from World War II) were abolished, thereby enabling foreign investors and institutions to acquire Swedish money market instruments and bonds. It appears there are no substantive constraints on foreign banks' activities in Sweden.

U.S. dollar figures calculated at the following rates:

1988: $1 = 6.44 SEK AA
1989: $1 = 6.13 SEK AA
1990: $1 = 6.13 SEK end-March

AA=Annual Average

33. Thailand - Banking

SUMMARY

Thailand's financial system is dominated by commercial banks. The system includes 29 commercial banks, 72 finance and securities companies, 22 finance companies, 11 securities companies, 18 credit fonciers (institutions that provide real estate development finance), a number of leasing companies, and 12 life insurance companies, along with a small number of specialized financial institutions. Commercial banks hold about three-fourths of the financial system's assets. Foreign banks account for only about 5 percent of commercial banking system assets; the assets of U.S. bank branches in Thailand accounted for slightly more than 1 percent of banking assets at year-end 1989.

The number of foreign banks operating in Thailand has remained static in recent years. During 1989, Finance Minister Pramual Sabhavasu held discussions with additional foreign banks interested in gaining banking licenses. The Royal Thai Cabinet subsequently refused to endorse his proposal to grant licenses to five new institutions at that time. No U.S. banks were among those competing for the new licenses because they felt the conditions for entry were too onerous.

Foreign banks in Thailand do not receive national treatment. Although foreign banks already established in Thailand receive the same treatment as domestically incorporated banks in many aspects of their operations, there are several areas where they face significant discriminatory limitations. Foreign banks are prohibited from opening new branches and precluded from joining the two Thai automated teller machine (ATM) networks. Thailand has stringent loan to capital restrictions and requires foreign banks to invest their capital in low-yielding government securities. The number of expatriate personnel is limited.

As noted above, significant denials of national treatment remain, and there has been no improvement.

At year-end 1989, U.S. banking corporations in Thailand operated three branches with assets of $659 million and owned seven subsidiaries with assets of $1.1 billion. This presence represents an increase of nearly $1 billion in assets since year-end 1985. At that time, three U.S. banks were operating three branches in Thailand with total assets of $408 million. Five U.S. banks also reported interests in Thai subsidiaries or affiliates with total assets of $300 million. Eight other U.S. banks maintained representative offices.

At the end of 1989, five Thai banks in the United States operated three agencies with assets of $352 million and six branches with assets of $577 million. There are no representative offices of Thai banks in the United States. This presence represents an increase in assets of $123 million since year-end 1985. At that time, five Thai banks operated six branches and three agencies in the United States with total assets of $806 million. Also as of year-end 1985, a Thai individual or individuals reported majority ownership of one U.S. bank with five branches and with total assets of $154 million.

OVERVIEW

Commercial bank activity dominates the Thai financial system. At the end of 1988, commercial banks accounted for 76 percent of total financial system assets, 76 percent of total deposits in the financial system, and nearly 82 percent of financial system loans.

Deposits in commercial banks totalled 1.189 trillion baht ($46.3 billion), of which foreign bank deposits constituted 2.3 percent. Credits extended by commercial banks totalled 1.159 trillion baht ($45.2 billion), of which foreign banks constituted 5.4 percent. There are 29 commercial banks with one or more branches in the Kingdom, of which 15 are locally incorporated institutions and 14 are foreign banks. The number of banks has fallen by one since the 1986 National Treatment Study Update due to the Government's August 1987 decision to merge Sayam Bank (formerly Asia Trust Bank, which failed in the mid-1980s) into the majority state-owned Krung Thai Bank. During 1989, there was a Ministry of Finance offer for sale at the Securities Exchange of Thailand (stock exchange) of a minority of the shares of Krung Thai Bank. This effort was not as successful as the Government had hoped. The bank remains majority state-owned.

Soon after assuming office, Finance Minister Pramual Sabhavasu announced that foreign commercial banks willing and able to meet his conditions could be awarded licenses to open a branch in Thailand. During 1989, representatives of some two dozen institutions held talks with Finance Ministry and Bank of Thailand officials on the issue. In February 1990, Pramual sought Royal Thai Cabinet endorsement of his proposal to award licenses to five banks: the Industrial Bank of Japan, Japan Long-Term Credit Bank, Sumitomo Bank, Westpac Banking Corporation, and Societe Generale. The Cabinet deferred a decision on the proposal. The Minister has indicated he would consider applications for licenses from other foreign banks (including the four additional institutions that were on his "short list" of nine candidates for licenses at the end of 1989), provided they meet his conditions.

Domestic Banking Market

Due in large part to double digit real economic growth in both 1988 and 1989, the Thai commercial banking system has grown rapidly in recent years. Total deposits in domestic banks in the system exceeded 1.155 trillion baht ($45 billion) at the end of 1989, or about 68 percent of Thailand's gross national product. Deposit growth in 1989 alone exceeded 25 percent. Thailand's economic vigor has also been good for commercial bank profitability. According to Bangkok Bank Limited, profits of Thai commercial banks exceeded 8.3 billion baht ($325 million) in 1989, up almost 50 percent from the 1988 figure.

At the end of 1989, banks incorporated in Thailand had 2,128 branches within Thailand and 21 branches and four representative offices abroad; the Thai Banks also operated a wide network of automated teller machines (ATM) using two competing ATM networks. Foreign banks had a total of 16 branches within Thailand. In early 1990, Standard and Chartered Bank announced it would be closing its Phuket branch -- the only foreign branch located outside Bangkok -- because the branch's major clients could be served as effectively from its Bangkok branch.

Measured in terms of deposits and assets, the role of foreign banks in the commercial banking system is marginal. Banks incorporated abroad held only 5.2 percent of the system's assets and 2.3 percent of the system's deposits at the end of 1989. In contrast, the four largest domestic banks held about 63 percent of the commercial banking system's assets and 66 percent of the system's deposits. Ranked by assets, these were Bangkok Bank Limited, Krung Thai Bank Limited, Thai Farmers Bank Limited, and the Siam Commercial Bank Limited. Bangkok Bank Limited alone held almost 27 percent of the commercial banking system's assets and more than 27 percent of the system's deposits.

Deposits of Thai Commercial Banks
(Million Baht)

	1988 December	1989 December	Percent Change
Bangkok Bank Ltd.	270,084	326,096	20.73
Krung Thai Bank Ltd.	145,664	185,009	27.01
The Thai Farmers Bank Ltd.	127,710	165,165	29.32
The Siam Commercial Bank Ltd.	84,011	112,307	33.68
The Bank of Ayudhya Ltd.	52,947	74,688	41.06
The Thai Military Bank Ltd.	56,705	69,185	22.00
The Siam City Bank Ltd.	32,748	40,461	23.55
Bangkok Metropolitan Bank	32,216	39,526	22.69
First Bangkok City Bank Ltd.	32,403	39,207	20.99
The Bangkok Bank of Commerce	29,140	34,268	17.59
The Bank of Asia Ltd.	21,596	26,176	21.20
The Union Bank of Bangkok Ltd.	15,218	17,822	17.11
The Thai Danu Bank Ltd.	11,340	15,761	38.98
Nakornthon Bank Ltd.	8,378	11,375	35.77
The Laem Thong Bank Ltd.	3,574	4,373	22.35
TOTAL	923,734	1,161,419	25.73

Credits of Thai Commercial Banks
(Million Baht)

	1988 December	1989 December	Percent Change
Bangkok Bank Ltd.	271,341	326,176	20.20
The Thai Farmers Bank Ltd.	111,900	153,728	37.37
Krung Thai Bank Ltd.	110,397	145,436	31.73
The Siam Commercial Bank Ltd.	72,800	95,678	31.42
The Bank of Ayudhya Ltd.	54,858	74,042	34.97
The Thai Military Bank Ltd.	48,907	65,156	33.22
First Bangkok City Bank Ltd.	33,403	42,847	28.27
The Siam City Bank Ltd.	33,608	40,675	21.02
Bangkok Metropolitan Bank	32,600	40,531	24.32
The Bangkok Bank of Commerce	27,406	36,841	34.42
The Bank of Asia Ltd.	23,918	27,669	15.68
The Union Bank of Bangkok Ltd.	13,859	17,378	25.39
The Thai Danu Bank Ltd.	11,267	15,699	39.33
Nakornthon Bank Ltd.	7,833	10,582	35.09
The Laem Thong Bank Ltd.	3,969	4,277	7.76
TOTAL	858,066	1,096,715	27.81

Deposits of Foreign Bank Branches in Thailand
(Million Baht)

	1988 December	1989 December	Percent Change
The Bank of Tokyo Ltd.	3,663.4	5,380.5	46.87
The Mitsui Bank Ltd.	3,499.4	3,586.1	43.47
Hongkong and Shanghai Banking Corp.	1,797.0	3,566.3	98.45
Standard Chartered Bank	1,295.5	3,445.7	165.97
Deutsche Bank AG	1,359.8	2,443.5	79.69
Citibank, N.A.	1,506.8	2,178.3	44.56
The Chase Manhattan Bank, N.A.	1,611.7	1,710.4	6.12
Banque Indosuez	1,158.6	1,378.1	18.94
Security Pacific Asian Bank Ltd.	370.8	1,210.9	226.56
Bank of America NT and SA	1,044.1	976.3	-6.49
Bharat Overseas Bank Ltd.	653.2	650.5	-0.41
The International Commercial Bank of China	417.3	635.6	52.31
United Malayan Banking Corp.	429.9	376.8	-12.35
Four Seas Communication Bank Ltd.	239.3	266.3	11.28
TOTAL	19,046.8	27,805.3	45.98

Credits of Foreign Bank Branches in Thailand
(Million Baht)

	1988 December	1989 December	Percent Change
The Bank of Tokyo Ltd.	9,493.5	15,266.3	60.80
The Mitsui Bank Ltd.	9,333.5	14,537.9	55.76
Citibank, N.A.	5,235.5	7,652.9	46.17
Deutsche Bank AG	4,065.8	5,710.8	40.45
The Chase Manhattan Bank, N.A.	3,644.9	4,301.2	18.00
Standard Chartered Bank	1,781.6	3,774.9	111.88
Banque Indosuez	2,856.7	3,471.6	21.52
Hongkong and Shanghai Banking Corp.	2,500.3	2,910.1	16.39
Bank of America NT and SA, Ltd.	2,229.2	1,814.8	-18.58
Bharat Overseas Bank Ltd.	877.1	1,181.5	34.70
Security Pacific Asian Bank Ltd.	638.4	1,064.8	66.79
The International Commercial Bank of China	439.5	630.1	43.36
United Malayan Banking Corp.	990.4	362.0	-63.44
Four Seas Communication Bank Ltd.	197.2	347.1	76.01
TOTAL	44,283.6	63,026.0	42.32

The second largest segment of Thailand's financial sector is composed of finance and securities firms as well as credit fonciers. The latter institutions were organized largely to help finance the purchase of real estate. The number of companies in this sector has been dropping for over a decade because of the decision to suspend the granting of new licenses, the revocation of some existing licenses and an active government policy of attempting to shore up ailing companies through mergers, acquisitions or other transactions. By the end of 1989, the number of finance and securities companies had fallen to 72, the number of finance companies to 22, and the number of securities companies to 11. The number of credit fonciers stood at 18. The consolidation of this segment of the system is continuing, mostly through the continued operation of the Bank of Thailand's (Central Bank) "lifeboat" scheme initiated in 1984.

Other elements in Thailand's financial system include a number of leasing companies, 12 life insurance companies, and certain specialized government financial institutions. The latter category includes the Government Housing Bank, the Government Savings Bank, the Bank for Agricultural Cooperatives, and the Industrial Finance Corporation of Thailand, which focuses in large part on lending for medium-term economic development.

All commercial banks, finance and securities companies, and credit fonciers come under the direct supervision of the Bank of Thailand (Central Bank). Because of widespread financial turbulence in the system during the mid-1980s, the Bank of Thailand subsequently received broader powers of surveillance and control over institutions in the system. The Ministry of Finance has also taken an increasing interest in bank regulation.

The Bank of Thailand imposes certain performance requirements and incentives on the institutions it supervises. For example, all commercial banks are required to keep the equivalent of at least 16 percent of their deposits in government bonds or in deposits, bonds or debt instruments issued by the Bank of Thailand or two Thai Government financial institutions. Total bank lending and lending to each individual customer is limited by a multiple of the bank's registered capital.

In addition, the Central Bank sees a role for itself being supportive of the country's specific economic development objectives. The Central Bank has encouraged domestic banks to open additional branches in rural areas where there were no formal financial institutions. The Central Bank has also required commercial banks to devote a specified portion of their lending to priority sectors, such as agriculture and development projects outside metropolitan Bangkok. The present "rural credit policy" requires all commercial banks in Thailand (including foreign bank branches) to allocate credit to rural areas equivalent to at least 20 percent of deposits, of which 14 percent must be given to agriculture directly and 6 percent to agro-business. More recently, lending for low income housing has also been encouraged officially although without any quotas or specific mandate.

Progress Since 1986: Since publication of the 1986 National Treatment Study Update, the Bank of Thailand has taken various measures to liberalize and promote competition in Thailand's financial sector. Interest rate ceilings on certain term deposits were abolished in June 1989. At the end of 1989, the Bank announced a relatively minor relaxation of the exchange controle regime. In March 1990, the Bank raised the interest rate ceiling on loans extended by commercial banks and other financial institutions while concurrently removing all ceilings on interest payable on fixed-term deposits. Despite these efforts to promote competition, however, the Thai Bankers Association, representing domestically incorporated banks, continues to seek (with some difficulty) price fixing agreements on the banks' deposit and lending rates.

U.S. Presence in the Market

Five U.S. commercial banks have operations in Thailand. Citibank and Bankers Trust International operate a total of seven subsidiaries, and Chase Manhattan Bank N.A., Bank of America N.T. and S.A., and Security Pacific Asian Bank (Bank of Canton Limited prior to July 1988) operate one branch each. Bankers Trust's subsidiary is engaged in investment rather than commercial banking activities. At the end of 1989, the subsidiaries had total assets of $1.1 billion, while the branches had total assets of $659 million. These U.S. banks had a 1.2 percent share of the total assets of all commercial banks operating branches in Thailand.

Credits extended by foreign banks in Thailand as of December 1989 totalled 63 billion baht ($2.5 billion), while foreign bank deposits totalled only 27.8 billion baht ($1.1 billion). In contrast to domestic banks, whose deposits exceed credits extended, foreign banks must fund lending through inter-bank borrowing.

The number of U.S. commercial banks which maintain representative offices in Bangkok has fallen in recent years and now totals seven. Some of these banks believe they can achieve their business objectives in Thailand without a permanent physical presence in the country.

Including the four U.S. commercial banks, 14 foreign banks representing 10 countries have branches in Thailand. As of December 1989, U.S. banks held 22 percent of foreign bank deposits and had extended 23.5 percent of foreign bank loans in Thailand. U.S. banks are the largest group of foreign banks; however, this would change if the Cabinet approves applications pending for five non-U.S. foreign banks to open branches in Thailand.

The country's largest life insurance company (American International Group/New Hampshire Insurance Co.) is fully owned by a corporation headquartered in the United States.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Although foreign banks already established in Thailand receive the same treatment as domestically incorporated banks in many aspects of their operations, there are several areas where they face significant discriminatory limitations. Foreign banks are not permitted to open new branch offices in Thailand. Except for branches grandfathered in the 1950s, all such banks have only one branch. In addition, Thai authorities define an automated teller machine (ATM) located outside the physical premises of the bank branch as a separate branch, effectively precluding a foreign bank from establishing its own ATM network. Foreign banks in Thailand are also precluded from joining the two competing ATM networks that were established to serve Thai commercial banks. In early 1990, the one U.S. bank with an active interest in Thailand's retail market was rebuffed in its attempt to join the Banknet ATM network, reportedly because existing institutions in the ATM network feared that the bank would provide strong competition. This U.S. bank in Thailand noted that the proscription on branching severely hinders its business development efforts. The combined effect of restrictions on branches and ATMs has hampered the ability of foreign banks to compete for baht deposits and has made them more dependent on the frequently more expensive inter-bank market, which is dominated by Thai banks.

The above-mentioned bank has attempted to deal with the restrictions on branching in part by the purchase of a finance and securities company. However, restrictions on the ability of foreign-owned finance and securities companies to branch may defeat this strategy. This restriction does not appear to be a violation of national treatment, however, because the Bank of Thailand follows a similarly restrictive policy concerning applications for new branches by domestically owned finance and securities firms. The Bank of Thailand has, however, indicated a certain flexibility with regard to branching in cases where a foreign commercial bank would be willing to acquire one of the severely troubled finance and securities companies taken over under the Government's "lifeboat" scheme.

In Thailand, stringent loan-to-capital ratios and the 25 percent legal lending limit, both based on branch capitalization, place foreign banks at a relative competitive disadvantage vis-a-vis the dominant Thai institutions. (Such limits also govern lending to individual customers.) Resident U.S. bankers are critical of the Royal Thai Government's requirement that all of their banks' capital has to be invested in Thai government securities which yield a low rate of return. With the National Government running a budget surplus, it has reduced domestic securities issues, making it difficult for at least one U.S. bank here to increase its capital. In early 1990, however, the Bank of Thailand announced plans to issue over 25.86 trillion baht ($1 billion) in bonds domestically, primarily to reduce excess liquidity in the financial system. Combined with a Finance Ministry move to offer government guarantees to local borrowing by Thailand's major state enterprises, this "shortage of securities" problem may be overcome.

Resident U.S. bankers are also critical of Bank of Thailand regulations which limit the number of expatriates (five) a foreign bank can employ. These bankers believe this restriction makes it difficult for the banks to continually offer innovative services. One banker also believes that the adverse effect of this restriction is heightened by the difficulty his institution has in locating and training qualified Thai personnel.

A major issue for all of the U.S. banks operating a branch in Thailand is a provision in the Thai revenue code that imposes a 10 percent withholding tax on foreign funds brought into Thailand but exempts the four Thai-owned banks with overseas branches from the withholding. In March 1989, the Government introduced an exemption from this withholding requirement as an element of a financial package to attract foreign funds. The withholding requirement went back into force in March 1990.

Other concerns U.S. bankers resident in Thailand have expressed include the inability of foreign companies (not solely financial institutions) to own land in Thailand. In certain cases, the banks own the building they occupy but not the land on which it is built.

There were no U.S. banks among the nearly two dozen foreign institutions which recently negotiated with Thai authorities for a license to operate a new bank branch in Thailand. Both resident and visiting U.S. bankers described the Finance Minister's conditions as "onerous" and not meriting serious consideration. Bankers were particularly concerned over what they considered the unduly high initial capital requirement, the limitations on business activities, the ceiling on the number of expatriate personnel, and the minimum amount of lending required within three years of establishment.

Domestic Securities Market

The trading of securities is a relatively new activity in Thailand. The Securities Exchange of Thailand (SET, the country's one stock exchange) opened for business in April 1975, the same year the small and privately owned Bangkok Stock Exchange shut down operations. The market has been volatile, with a collapse in early 1979, followed by a period of improvement between early 1986 and the worldwide stock market collapse of October 1987. The SET has since recovered, with the SET index more than doubling in the 11 months ending in December 1989. According to the Bank of Thailand, the number of listed and authorized companies on the SET rose to 175 at the end of 1989, with market capitalization of listed and authorized securities rising to 38.7 percent of GDP.

There are two types of companies participating in the Thai securities business: securities companies; finance and securities companies. The Alien Business Law of 1972 prohibits foreign citizens from engaging in certain occupations, including the brokerage business. Securities companies with less than 50 percent foreign ownership can participate in brokerage activities. For finance and securities companies, the foreign ownership limit is 25 percent, with an exception for those companies established before 1979, which can have up to 50 percent foreign ownership. For example, Bankers Trust holds a controlling share in one of the country's largest and most successful brokerage houses. The U.S. banks already established in Thailand have all expressed interest in entering the brokerage business, as have some of the largest U.S.-based financial services firms. However, near-term change is unlikely in the Bank of Thailand's "no new brokerage licenses" policy.

CONCLUSION

Significant denials of national treatment remain and there has been no improvement. The treatment of foreign banks in Thailand has not changed since 1986. Foreign banks are still limited to only one branch office, and may not join a Thai ATM network nor initiate one of their own. Operations of foreign banks are also impaired by stringent loan to capital ratios based on branch capitalization and the requirement to invest their capital in low-yielding government securities. Moreover, a 10 percent withholding tax on foreign funds brought into Thailand is imposed on U.S. banks because of the absence of a bilateral tax treaty between the United States and Thailand.

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*U.S. dollar figures calculated at the following rates:

1989: $1 = baht 25.68 AA; 25.69 YE
1990: $1 = baht 25.86 (June 25, 1990)

AA = Annual Average
YE = Year-End

34. Turkey - Banking

SUMMARY

The financial sector is changing rapidly as the Government of Turkey develops and liberalizes the economy as a whole. With the support of the World Bank, new financial institutions have been created and new policies adopted to increase the efficient allocation of resources. Liberalization of currency convertibility provisions has stimulated foreign investment in capital markets. Further reforms are contemplated to deal with problems of loan concentration and capital adequacy.

Capital markets form a relatively small part of the financial sector but are growing rapidly. Markets have been stimulated by the relatively low return on alternative investment opportunities and liberalized access of foreigners to Turkish capital markets.

U.S. and other foreign banks have been an important force stimulating modernization of the Turkish banking system. Four U.S. banks are among the 16 branches of foreign banks established in Turkey and two U.S. banks have formed joint ventures with Turkish firms.

U.S. banks find that erosion of their capital by inflation is a problem since legal lending limits are linked to capital and foreign banks cannot revalue fixed assets as can domestic banks. Bankers are examining their options for staying in this profitable market, including converting to subsidiaries.

There is no discrimination against foreign banks in Turkish law.

At year-end 1989, U.S. banks in Turkey operated six branches with assets of $267 million and a subsidiary with assets of $3.4 million. There were no U.S. bank subsidiaries in Turkey in 1986.

At the end of 1989, one Turkish bank operated one branch with assets of $385 million in the United States. Turkish banks maintain three representative offices in the United States.

OVERVIEW

The banking sector in Turkey has progressed rapidly since the beginning of this decade with strong support from the World Bank. The financial sector has been dramatically liberalized as part of the Government's policy of opening the economy to market forces and international competition. The 1985 Banking Act overhauled the banking system, setting lending limits to reduce loan concentration, strengthening banking supervision by the Government, and creating a deposit insurance fund.

Since 1986, several new specialized financial markets have been created: an interbank market, which has become an important source of short-term liquidity; the foreign exchange and foreign currency money markets, which have improved management of banks' foreign exchange holdings and a gold market which has legalized gold imports. The Istanbul Center for International Banking Studies, which is operated under contract with Citibank, was created to train banking personnel in modern technologies and techniques. The State Investment Bank was converted to the Turkish Export-Import Bank in 1987 to assist Turkish exporters.

A number of policy actions have also been initiated as part of the Government's program to deepen financial markets. Standard accounting practices were introduced in 1986 to enhance the transparency of financial transactions. Financial instruments were diversified by the addition of commercial paper in 1987. The Central Bank began open market operations in 1987 which allowed for greater latitude in implementation of monetary policy. Reforms introduced in February and again in October 1988 tightened the Central Bank's reserve (liquidity) requirements while freeing up deposit interest rates.

Further reforms are needed to mobilize resources and increase the efficiency of resource allocation in Turkey's economy. The Banking Act is under review and major reforms regarding capital adequacy, an institution to deal with insolvencies, and investment banking activities are expected later this year. The new law would encourage commercial banks to divest themselves of their industrial affiliates by narrowing the limits on holdings from the current 100 percent of net assets to 50 percent over a three-year period. Under the new law, investment banks would not be permitted to take deposits.

There are also plans to privatize all state banks (except T.C. Ziraat Bankasi, Turkey's oldest and largest bank), starting with Denizbank, Tobank and Sumerbank. Also under consideration are amendments to the Capital Markets Law which would give the Capital Markets Board greater authority over investment banking activities of commercial banks. Finally, the Government is investigating possible reforms of the insurance sector.

Domestic Banking Market

The financial sector is dominated by the banking sector, which controls an estimated 80 percent of Turkey's financial assets. The social security system, insurance and securities market play relatively minor roles. As of mid-1990, the banking sector was composed of the Central Bank, 32 commercial banks (24 of which were privately owned), 10 development and investment banks (half of which are privately owned), and 22 foreign banks (17 of which are branches). In 1990 Societe Generale established a branch and a new investment bank, Euroturk Bank, was authorized. There were also three private finance houses that practice Islamic banking.

Banks By Type	Number of Banks (Nov. 1989)	Total Assets (Dec. 1989) TL Billion	Percent of Total
Central Bank	1	52.526	31.8
National Commercial Banks	32	98.967	59.8
State Banks	(8)	(52.483)	(31.7)
Privately Owned Banks	(24)	(46.484)	(28.1)
Development/Investment Banks	9	10.418	6.3
State Banks	(3)	(7.715)	(4.7)
Privately Owned Banks	(6)	(2.702)	(1.6)
Other Commercial Banks	21	3.453	2.1
Banks Founded in Turkey	(5)	(1.978)	(1.2)
Foreign Banks with Branch Offices	(16)	(1.474)	(0.9)
of Which U.S. Banks	(4)	(0.532)	(0.3)
Total	63	165.364	100.0

(1) Does not include Euroturk Bank, which was established in 1990.
(2) Does not include Societe Generale, which was established in 1990.

Source: Capital Markets Board

The banking sector is extensive but highly concentrated. At the end of 1989, 161,018 people were employed in a network of more than 6,617 branches. The seven largest banks controlled two-thirds of total assets, three-quarters of total deposits and conducted nearly two-thirds of total lending.

BANKS IN TURKEY
(As of the End of 1989)

National Commercial Banks	No. Branches	No. Employees	Paid In Capital Bil Tl	1989 Profit Mil Tl
State Banks				
Denizcilik Bankasi	51	1,174	29	3
Etibank	129	2,792	489	283
Sumerbank	46	711	270	2
TC Ziraat Bankasi	1,245	41,059	394	253
Emlak Bankasi	438	11,276	173	30
Halk Bankasi	667	14,504	153	5
Ogretmenler Bankasi	96	1,925	123	2
Vakiflar Bankasi	300	6,700	250	150
Privately Owned				
Adabank	4	84	10	1
Akbank	617	9,819	500	345
Demirbank	19	554	18	7
Egebank	38	769	40	2
Eskisehir Bankasi	33	929	81	28
Finansbank	4	242	20	32
Iktisat Bankasi	18	778	18	35
KOC - Amerikan Bank (1)	5	210	14	8
Milli Aydin Bankasi	30	582	15	5
Netbank	4	167	14	6
Pamukbank	190	3,040	173	11
Sekerbank	169	3,172	29	20
Tekstil Bankasi	3	141	10	7
T. Dis Ticaret Bankasi	21	1,002	50	20
Turk Economi Bankasi	6	480	76	39
Turk Ticaret Bankasi	410	7,972	50	51
T. Garanti Bankasi	297	5,179	200	71
T. Imar Bankasi	22	470	42	2
T. Is Bankasi	947	20,212	195	124
Ithalat-Ihracat Bankasi	5	216	10	4
T. Turizm Yatirim Ve Dis Ticaret Bankasi	2	76	16	4
T. Tutunculer Bankasi (2)	44	1,011	33	8
Uluslararasi Endustri Ve Ticaret Bankasi	15	280	80	63
Yapi Ve Kredi Bankasi	598	10,656	195	134
Total	6,473	148,182	3,770	1,028

(1) American Express owns 49 percent, KOC holding 51.

(2) U.S.-based Irving Trust held 43 percent but sold out in 1988.

Foreign Banks	No. Branches	Country Origin	1989 Profit Mil Tl
Founded in Turkey			
ARAP - Turk Bankasi (1)	4	Libya/Kuwait	n.a.
Turk Mutsui Bank (2)	2	Japan	2
United Turk Korfez Bankasi	1	Qatar	10
Osmanli Bankasi (3)	71	U.K./France	32
BNP/Akbank/Dresdner (3)	1	France/Germany	15
Other Foreign Branch Offices			
Bank Mellat	2	Iran	4
Bank of Bahrain/Kuwait	1	Bahrain	1
Bank of Credit and Commerce International	3	Luxembourg	n.a.
Banco Di Roma	2	Italy	2
Banque Indosuez	1	France	6
Credit Lyonnais	1	France	8
Habib Bank Limited	2	Pakistan	2
Holantse Bank Uni. N.V.	1	Netherlands	5
Standard Chartered (4)	1	Great Britain	9
Turk Bankasi Limited	2	N. Cyprus	3
Kibris Kredi Bankasi	1	N. Cyprus	1
Societe Generale (5)	1	France	n.a.
U.S. Branch Offices			
Bank of Boston	1	USA	5
Chase Manhattan	1	USA	6
Citibank N.A.	3	USA	5
Manufacturers Hanover	1	USA	17
Saudi American Bank (6)	1	USA	6

	Branches	Employees	Capital Bil Tl	1989 Profit Mil Tl
Development/Investment Banks				
State Banks				
Iller Bankasi (7)	1	119	300	15
T. Ihracat Kredi Bankasi (8)	1	300	500	26
T. Kalkinma Bankasi(9)	2	885	200	11
Privately Owned Banks				
Sinai Yatirim Ve Kredi Bankasi	1	139	20	16
T. Sinai Kalkinma Bankasi	4	407	100	18
Yatirim Bankasi	1	13	5	1
United Yatirim Bank	1	22	8	n.a.
Tekfen Yatirim Ve Finance B.	1	25	10	1
Turk Merchant Bank (10)	1	45	6	7
Euroturk Bank (11)	1	n.a.	10	n.a.

Sources: Central Bank of Turkey, Quarterly Bulletin, 1990 I; "Banks in Turkey-1989," Banks Association of Turkey, May 1990.

Notes:

(1) Due to the Gulf Crisis, the ownership rights of Kuwait have been transferred and will be governed by Vakiflar Bankasi.

(2) Chemical Bank sold its 25 percent interest in 1988.

(3) BNP/Akbank was a private commercial bank until Dresdner bought an interest in 1989.

(4) Standard Chartered transferred all its branches in nine European countries to Westdeutsche Landesbank. under a merger agreement, dated December 1989. On September 1, 1990, the name of the bank became Westdeutsche Landesbank.

(5) Societe Generale opened its branch in early 1990.

(6) Citibank controls 40 percent and operates Saudi American Bank under a management contract.

(7) This is the State Institution for Administration of Provinces and Municipalities.

(8) T. Ihracat Kredi Bankasi was reorganized in August 1987 as the Turkish Export Import Bank.

(9) Kalkinma Bankasi took over the Tourism Bankasi in February 1989.

(10) U.S. Bankers Trust owns 60 percent and Is Bankasi owns 40 percent of Turk Merchant Bank.

(11) Euroturk Bank opened in early 1990.

Banks in Turkey are permitted wide latitude in their activities. Many commercial and development banks in Turkey engage in universal banking. In addition to regular commercial banking activities, such as taking deposits and lending, banks can participate indirectly in trade and industry. Banks may either issue securities to meet their own financial needs or act as intermediaries in primary and secondary capital markets.

Many banks also benefit from interlocking ownership with major industrial conglomerates. Sumerbank, for example, is deeply involved in the textiles industry and Is Bankasi owns, among other industrial concerns, Turkey's preeminent glass and crystal manufacturer. Non-interest income accounted for 27 percent of the banking sector's total income in 1989.

The relationships of Turkish banks with the conglomerates may interfere with the efficient allocation of credit. Banks are reported to extend preferential credits to these borrowers, resulting in loan concentration and artificially high lending rates. Such borrowing may "crowd out" and raise interest rates for companies without such a preferential relationship. These high rates in turn may undermine the stability of the financial system by increasing the incidence of nonperforming loans.

The Government has strengthened its supervision procedures, reduced preferential lending, introduced standard accounting practices and required provisions against potential losses. However, the large number of nonperforming loans and high lending rates are still cause for concern. Capital adequacy requirements have gradually been raised, starting in 1988, to bring Turkish requirements in conformity with European Community standards.

Three private finance houses practice Islamic banking, i.e., returns on deposits and loans are in a form other than interest. Al Baraka Finance House and Faisal Finance House were established as joint-stock companies in 1985 and 1984, respectively. Kuwait Turk Evkaf followed in 1988. Finance houses may establish accounts denominated either in Turkish lira or foreign exchange and engage in foreign exchange transactions. Profits from accounts are deposited in the private finance houses' participatory accounts, and account holders accrue income (or losses) according to earnings from the participatory accounts. Private finance houses are not covered by the Savings Deposit Insurance Fund nor are they subject to reserve and liquidity requirements, but their capital requirements are the same as for banks.

U.S. Presence in the Market

Four U.S. banks have branches in Turkey. They include Bank of Boston, Chase Manhattan, Citicorp, and Manufacturers Hanover. In addition, American Express owns 49 percent of the Koc-American Bank and Bankers Trust owns 60 percent of Turk Merchant Bank. Chemical Bank and Irving Trust were involved in joint ventures but have left the market.

U.S. and other foreign banks have played an important role in stimulating competition in and modernization of Turkish banking. Most U.S. banks have established branch offices which are relatively small and concentrate on specialized activities, mainly trade finance and foreign exchange transactions, for a small number of large corporate and multinational customers. Syndications and investment banking activities are also important sources of revenue. Foreign banks are empowered to take deposits, but prefer to rely on the interbank market as a source of funds. Competition has shrunk formerly lucrative margins on trade finance, so foreign banks are creating new instruments, providing new services and expanding their customer base to remain competitive.

With the notable exception of Osmanli Bankasi, which functioned as the Central Bank of Turkey until the Republic was founded in 1923, European banks were not previously very involved in the Turkish market. European banks are now showing greater interest in direct participation. Middle Eastern banks entered the market in the mid-1980s, the same time as most U.S. banks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Turkish law does not discriminate against foreign financial institutions. The laws and regulations governing the establishment and operations of foreign banks are the same for domestic banks. The minimum capital requirement for commercial banks will soon be raised to TL 75 billion ($30 million) and to TL 50 billion ($20 million) for investment banks.

This higher capital requirement will be difficult for domestic and foreign banks to meet, and may force the latter to import additional capital. Turkish and foreign banks alike face the problem of capital erosion from inflation, although Turkish banks may revalue their fixed assets as a part of capital. Foreign bank branches not meeting capital requirements at the end of each year are required to replenish their capital by bringing in additional foreign exchange.

Some U.S. banks are considering converting from branches to subsidiaries to improve their ability to avoid capital erosion from inflation. Subsidiaries are allowed to revalue their real estate holdings in calculating their capital. They are also allowed to revalue earnings quarterly and include fixed assets in capital as a hedge against inflation. Subsidiary status also permits banks a wider range of activities, including issuing commercial paper and participating in the capital markets.

Another issue of concern to U.S. banks, due to their dependence on the inter-bank market for funding, is the assessment of a withholding tax on inter-bank transactions. Lenders, which are mainly large deposit-taking banks, have been able to pass much of the cost of the withholding tax on to borrowers, usually small banks, including foreign banks. Withholding taxes may be credited at year-end against corporate income taxes, but the fact that institutions that lend in the inter-bank market can offer short-term funds to their clients at a lower rate than other institutions, which fund themselves in the inter-bank market, has created a two-tiered market.

Domestic Securities Markets

Capital markets are developing rapidly in Turkey. A new Capital Markets Law was passed in 1981, the Capital Markets Board was established in 1982 and after years of inactivity, the Istanbul Stock Exchange reopened in January 1986. The Istanbul Stock Exchange (ISE) is charged with "developing and maintaining the central securities market of Turkey to benefit the economy in general and Turkish capital markets in particular."

Transactions on the ISE are divided between senior and junior markets. Some 50 primary or "blue chip" companies are traded on the senior market and the rest are traded in the junior market. The main types of securities traded on the ISE include corporate equities, corporate bonds, government bonds, Treasury bills and revenue sharing notes. All transactions are currently on a cash or spot basis; there are no forward nor options markets. The exchange is open only two hours daily and is highly volatile.

The Istanbul Stock Exchange (ISE) has rapidly increased its volume of operations. The ISE index increased 493 percent in 1989 to close at a high 2217.66 on December 29. In 1990, the ISE has continued to expand, reaching all-time high of 53.48 on the last day of July. The trading value of the Istanbul Stock Exchange grew 11 fold in 1989 and the number of shares transacted increased by 6.5 times. Market capitalization of the major board rose to TL 15.53 trillion ($7.3 billion), nearly seven times the 1988 figure.

Officials of the ISE attribute recent expansion in the market to low returns on alternative investment opportunities. Time deposits continue to attract the bulk of savings but interest rates, as noted previously, declined in 1989 from the peaks reached in late 1988. Measures taken in August 1989 opened the stock exchange to foreign institutional and individual investors. Previously, only foreign mutual funds had access to the ISE. Investors are completely free to repatriate earnings on their holdings or proceeds from sales. Turks residing in Turkey are equally free to purchase foreign securities.

The ISE continues to expand and deepen as a result of continuing reforms. The Capital Markets Board reported that permits to issue securities from January to July 1990, increased 180 percent over the same period in 1989.

In March 1990, the Government announced it would use the extensive computer and branch network of I.S. Bankasi throughout Turkey for sales of stock in connection with its privatization program, and in August 1990 trading was allowed outside the stock exchange in odd lots within predetermined price margins. The next step will be to computerize private transactions, remove the bottlenecks on settlement and open the way for further expansion of the Exchange.

CONCLUSION

Foreign banks receive *de jure* national treatment. As a matter of law and policy, there is no discrimination against foreign financial institutions. The establishment of banks and their operations are governed by the same laws and regulations that govern national banks.

Despite equal status under the law, foreign banks are at the following financial and competitive disadvantages:

(a) The value of their capital, which is linked to legal lending limits, has been eroded by inflation. Foreign banks cannot hedge inflation through revaluation of fixed assets (as their domestic competitors can) and they cannot use their global capital to meet lending limits; and

(b) As borrowers, dependent on the interbank market, they pay withholding taxes, which puts them at a price disadvantage when on-lending, even though this cost may be credited against annual income taxes.

U.S. banks in Turkey remain profitable, but are reexamining their options including the possibility of converting branches to subsidiaries.

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[*] U.S. dollar figures calculated at the following rates:

1988: $1 = TL 1,422.3 AA
1989: $1 = TL 2,121.7 AA
1990: $1 = TL 2,522.0 (end-April, 1990)

AA = Annual Average

35. Union Of Soviet Socialist Republics - Banking

SUMMARY

The Soviet banking system is controlled by the state. Although foreign banks are currently restricted to international business conducted through representative offices, legislation has been introduced that may lead to privatization of and full, unrestricted foreign participation in the financial sector.

While foreign banks do not currently receive national treatment, liberalization is expected in the near future.

Two U.S. banks have representative offices in the Soviet Union. One Soviet bank maintains a representative office in the United States.

OVERVIEW

This chapter describes the Soviet banking system as of mid-year 1990. Major changes have resulted from a July 1987 decree on banking reform. Further major reforms are currently under consideration, including greater autonomy for commercial banks and the transformation of the Gosbank, or State Bank, into a Western-style central bank. These reforms would also place commercial bank operations on a private market basis.

Domestic Banking Market

The domestic banking system in the Soviet Union is completely owned and controlled by the state. All banking operations are overseen by the Gosbank. Soviet banks can be divided into three principal types: commercial banks, specialized domestic banks, and international banks. Twenty foreign banks, including two U.S. banks, have representative offices in the Soviet Union.

The Gosbank functions as the Soviet central bank. It sets lending policies, regulates the money supply, sets official exchange rates and represents the Soviet Union in relations with other central banks. While the Gosbank sets general guidelines for interest rates, the specialized and local banks have the authority to vary the rates they charge by a certain amount. Gross loan limits are determined by the Gosbank.

Commercial banks or savings banks can be formed by individual investors or cooperatives, and as such were until very recently the only kind of private bank in the system.

These banks provide many of the consumer functions common in Western commercial banks, such as settling accounts and making housing and consumer loans.

The commercial banks make loans subject to an overall ceiling and loan criteria set by Gosbank. They may set their own interest rates, within a certain percentage of Gosbank's guideline rates.

There are four specialized or "industrial" banks in the Soviet system, each of which lends to a different sector. Of the four, Agroprombank and Zhilsotsbank have been recently transformed by the Central Government into share-issuing commercial banks. The other two banks are controlled by the Government. The government-controlled banks provide low-interest financing to unprofitable enterprises so that they can remain in operation; although the recently privatized banks do not.

The Agroprombank (Bank for Agriculture and Industry) serves the agroindustrial complex, including state and collective farms, rural cooperatives and food industry enterprises. The Promstroybank (Industrial Construction Bank) supplies capital investment loans to state enterprises in construction, transportation, communications and other heavy industries. The Zhilsotsbank (Housing and Municipal Services and Social Development Bank) provides financing for housing and municipal services. It is also the major source of loans to cooperatives, private individuals, and local soviets. The Sberbank provides savings and credit services to individuals.

Agroprombank and Zhilsotsbank have been issued licenses to engage in hard currency operations as well.

The principal institution on the international side is the Vneshekonombank (VEB, or Bank for Foreign Economic Affairs), which oversees and finances all foreign trade transactions. The VEB also supervises the operations of the five Soviet-owned overseas banks:

Banque Commerciale pour l'Europe du Nord (Paris),

Donau Bank (Vienna),

East-West United Bank (Luxembourg),

Moscow Narodny Bank (London) and

Ost-West Handelsbank (Frankfurt).

These banks operate under the management of Soviet officials, subject to local banking regulation and supervision.

U.S. Presence in the Market

Foreign banking presence in the Soviet Union is minimal. Twenty foreign banks, including two U.S. banks, have representative offices there. Recent reforms may lead in time to a substantial increase in opportunities for foreign banks in the Soviet Union.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks are currently prohibited from doing business in the domestic Soviet market, but may represent the interests of foreign clients through local representative offices.

Domestic Securities Market

There is no securities market in the Soviet Union. The Government has very recently begun to experiment with new methods of financing, including the issuance of notes and bonds. The amounts outstanding so far are *de minimis* and there is currently no method for trading in these instruments.

CONCLUSION

While foreign banks do not currently receive national treatment, liberalization is expected in the near future. U.S. banks may not operate in the domestic banking market of the Soviet Union. They may represent foreign clients through representative offices. There is no securities market in the Soviet Union.

36. France - Securities

SUMMARY

During the past few years, the French Government has eliminated virtually all legal and other restrictions which hampered or discriminated against the participation of U.S. and foreign firms in securities activities in France. This was done in the context of comprehensive deregulation and reform of the French financial system, which was designed to transform Paris into a modern, diversified, liquid financial market -- the number one center in continental Europe. In fact, a feature of this strategy has been an effort to attract foreign financial firms for their capital as well as their expertise.

Foreign firms are now authorized to own French brokerages. In the important government debt market, the change to exclusive issuance by auction and the establishment of a primary dealer system open to foreign firms has created competitive opportunities for non-French financial institutions. Likewise, the progressive elimination of exchange controls has put foreign financial firms, with their comparative advantage in foreign securities, on stronger footing in attracting business in the French marketplace.

The U.S. financial sector is well-represented in France's expanding and increasingly sophisticated financial markets. Most of the major money center banks, the large investment houses and Wall Street brokerages have offices in Paris. U.S. financial firms are active participants in the full range of securities activities in France, both in the primary and secondary markets. With their expertise in mergers and acquisitions, securitization and specialized and hybrid financial instruments, U.S. financial firms have played an active and remarkably unrestrained role in the blossoming of securities activity in France.

There are only two areas in which U.S. firms formally are denied national treatment. French foreign direct investment regulations, although significantly liberalized, discriminate against non-EC firms making acquisitions (financial and nonfinancial) by subjecting them to review by the Ministry of Finance. These regulations do not appear to have been used to block U.S. acquisitions in the financial sector, but their existence could dissuade efforts to acquire high-profile French financial

institutions. In the second identified problem area, French authorities, as a matter of policy, bar U.S. financial institutions from lead managing private and public sector domestic bond issues, arguing that French commercial banks cannot lead manage or underwrite bond issues in the U.S. due to Glass-Steagall provisions.

Nevertheless, entry is easy and national treatment is accorded in almost all instances.

OVERVIEW

Domestic Securities Markets

French financial institutions operate within a universal banking system. The Banking Law of 1984 permits institutions holding a banking license to engage in the full range of securities activities. Nonbank financial institutions licensed as Maison de Titres are also authorized to undertake securities activities, including operating in money and futures markets. The Stock Exchange Law of 1988 eliminated the legal barriers that had previously separated the brokerage business from other financial activities. As a result of these reforms, French banks and their affiliates dominate the securities markets.

Following a steady diet of reform and deregulation, the French financial system has been radically transformed over the last six years into a modern diversified financial system, exposed to competition and with an international outlook. Since 1984, the Government has enacted a series of laws and regulations laying the framework for the creation of a unified network of equity, bond, derivative and money markets patterned in large part on Anglo-Saxon models.

With the adoption of a universal banking system in 1984, the Government began an overhaul of the government securities market in 1985, changing operating techniques and introducing a new variety of debt instruments. Certificates of deposit and commercial paper open to all investors were first authorized in 1985 as well. A futures market was launched in 1986 and a stock options market the following year. As a result of a law passed in 1988, the system of government-appointed stock brokers, a system dating back to the rule of Napoleon, was radically changed. Exchange restrictions were progressively eliminated, and in December 1989, the final restriction limiting individuals' holdings was lifted. The reform program was devoid of efforts to raise legal or regulatory barriers to foreign participation in French financial markets, reflecting the Government's recognition that foreign financial institutions could contribute to the efficiency, innovation, size and stature of Paris financial markets.

Since the mid-1980s, the Paris financial markets have expanded at a rapid pace, tripling and quadrupling in size. They remain generally small in comparison to the U.S., the U.K. and Japan, but are bigger and more dynamic than other continental markets.

The Equity and Bond Markets: The French stock market consists of the Paris Bourse and regional exchanges. By 1991, however, the regional bourses will be folded into the Paris Bourse, which will be divided into two compartments: one for actively traded shares of major national or international companies, and one for less active issues of primarily regional interest. About 600 French companies are currently traded on the official market, and another 300 French companies on the second market (for lesser known or smaller companies). About 220 foreign companies are listed on the Paris Bourse. Based on 1988 figures, the French stock market ranked fifth in the world in terms of capitalization, far behind the U.S., Japan and the U.K., and almost on par with Germany. At the end of 1989, equity capitalization on the Paris Bourse was FF2.1 trillion ($365 billion)*, about 30 percent of gross domestic product, low in comparison to the top three stock markets. While small, the volume of new equity issues has been steadily increasing, from FF17 billion ($2 billion) in 1985 to FF56 billion ($9 billion) in 1989. Market value of French bonds outstanding at the end of 1989 equaled FF2.2 trillion ($380 billion), an increase of 40 percent since 1985. Liquidity on the French Bourse has improved significantly since the mid-eighties as annual trading volumes in stocks and bonds jumped almost five times, reaching FF4.0 trillion ($627 billion) in 1989.

Prior to 1988, trading on the Bourse in equities and bonds was the sole privilege of 102 stockbrokers (French citizens) appointed by the Ministry of Finance and organized in 61 independent firms. The Stock Exchange Law of January 1988 changed this in a number of ways. Brokers lost their status as government officials personally liable for their transactions, while membership in the Bourse was transferred from individuals to incorporated firms. The 61 firms in operation were automatically granted membership in the Bourse, but their capital was opened to any company -- financial, industrial or commercial, French or foreign. And, while the number of firms currently remains fixed, creation of new brokerage firms will, in principle, be possible as of January 1, 1992. At end-1989, only a handful of French brokerages remained independent, the majority having been bought by banks and insurance companies, representing some eight different nationalities.

The Futures Market: The MATIF, the French financial futures market, has grown at a rapid pace during its four years of existence. Six futures contracts and two options on futures contracts are now traded, including contracts based on a 10-year notional government bond, three-month PIBOR (Paris Interbank Offered Rate) and a stock index. In 1989, the MATIF introduced its first international product, a EuroDM contract. Based on volume data for the first nine months of 1990, the MATIF has become the fourth largest financial futures market, behind the two Chicago exchanges and London, but ahead of Tokyo. Daily turnover on the 10-year notional government bond contract, the most heavily traded product, reached an average of over 60,000 contracts in 1989.

The MATIF currently has 100 member firms, 25 percent of which are foreign-owned. Any financial institution, French or foreign, holding a banking license or established as a nonbank financial institution (Maison de Titres) can apply for membership in a clearing capacity. In a move to internationalize further its products, participants and clientele, the MATIF has also agreed to join the 24-hour electronically linked GLOBEX system (developed by the Chicago Mercantile Exchange and Reuters) which is expected to begin functioning in Paris by late 1990/early 1991. Once operative, members of the participating futures exchanges will be able to trade each other's contracts outside the normal operating hours of each exchange.

The Stock Options Market: The French stock options market (MONEP) has grown steadily since its creation in 1987. After two years in operation, 3.5 million options were negotiated in 1989, an 80 percent increase over the previous year in average daily trading of 15,000 contracts. The value of options traded reached FF11 billion ($2 billion) and the number of stocks offering options doubled from an initial 8 to 16 at the end of 1989. Forty-five registered brokers on the Paris Bourse are authorized to trade these options and they act as clearers as well.

Government and Corporate Debt Market: In 1985, the French Treasury replaced its existing system of underwriting government securities through a designated bank syndicate with the more competitive system of public auctions. In 1987, it established a primary dealer system involving thirteen financial institutions (based on the U.S. model) and introduced a regular issuing schedule, for both bonds and bills. At the end of 1989, outstanding French franc government securities totaled FF1.2 trillion ($207 billion), of which FF710 billion ($123 billion) were in bonds. While this represents an increase of almost 50 percent since 1986, the domestic French government bond market is significantly smaller than comparable markets in the U.S., the U.K., Japan and Germany.

The Ministry of Finance arranges in conjunction with the banks the calendar of issues of public and private sector FF bonds above FF1 billion ($175 million) and of all EuroFF bonds principally to protect issuers and their bankers against market flooding. The goal is to promote market stability and efficiency. Most corporate bond issues of the private or public sector are underwritten by a syndicate, with a French bank serving as lead manager. At end-1989, the value of outstanding nonfinancial corporate bonds totaled FF306 billion ($53 billion), an increase of 15 percent over the previous year, although gross bond issues of the nonfinancial corporate sector declined 14 percent in 1989.

Mutual Funds: Mutual funds, first authorized in France in 1979, have grown rapidly. Over 4,800, primarily small close-ended funds, now operate in France, with an outstanding value of FF1.4 trillion ($234 billion) at the end of 1988. More than 800, however, are open-ended investment funds (SICAV), comparable to American mutual funds, which account for approximately 75 percent of total assets. France ranks number one in the EC in mutual funds, accounting for over 40 percent of total EC market value, and third in the world behind the U.S. and Japan. About 90 percent of French mutual funds are managed by French banks, 70 percent by 10 banks alone. However, as of October 1, 1989, EC-origin mutual funds can be sold in any EC country, provided that the origin country has harmonized its laws with the EC UCITS (Mutual Fund) Directive. Mutual funds managed by companies outside the EC must receive authorization from the Ministry of Finance.

Regulatory Authorities: Regulation of financial institutions is the joint responsibility of the Ministry of Finance and the Bank of France, with the latter charged with overseeing the licensing process, minimum capital requirements and the establishment of prudential and solvency ratios. The Commission des Operations de Bourses (COB), the French SEC, has jurisdiction over all financial markets and approves the creation of mutual funds. Establishment of the overall rules governing operations of the stock/options and futures markets is the responsibility of two self-regulatory bodies established by statute, the Conseil des Bourse de Valeurs for the stock and options markets and the Conseil des Marches a Terme for the futures market. These bodies define the terms and conditions for membership in their respective exchanges and provide oversight of the daily functioning of the markets. A government representative sits on the board of these two bodies.

U.S. Presence in the Market

U.S. financial firms participate in the full spectrum of securities activities in France, though they are by no means major players. Fifteen U.S. banks have offices in Paris, including the majority of U.S. money center banks and some regionals. Only one U.S. bank, however, bases its European headquarters in France. All but a few banks have set up subsidiaries to allow them to operate in the French financial markets; however, even those with a subsidiary generally choose to maintain status as a branch for other financial, mainly commercial banking, activities. Four major U.S. investment houses are also present in Paris. About eight U.S. brokerage firms have offices in Paris as well, but their business, in large part, is geared to selling dollar-denominated instruments to French investors. Since they do not have a banking license, those U.S. investment houses and brokers that want to participate in the French securities business generally establish themselves as Maison de Titres. This allows them to engage in a range of securities activities: portfolio management, money market operations, acquiring a seat on the MATIF or setting up mutual funds. In addition to their banking license, several U.S. banks have also acquired status as a Maison de Titres to undertake certain securities activities, due to U.S. regulations.

U.S. firms are well represented on the French futures market: of the 25 foreign members of the MATIF over 15 are American. Only two U.S. banks have bought French brokerages since 1988, when they were first opened to foreign investors, but that appears to have reflected purely business calculations. In the government debt market, an American Bank was chosen to be one of the initial thirteen primary dealers, and a second U.S. bank is one of four other banks awarded limited primary dealer status for a two-year probationary period.

U.S. financial firms are active and particularly competitive in arranging specialized financial instruments, such as warrants, swaps and a range of bond/equity hybrids. They are also active traders in the secondary government debt market. Some of the larger U.S. banks in Paris manage mutual funds. U.S. financial institutions with expertise in innovative financial arrangements have particularly profited from the increased number of mergers and acquisitions in France during the last few years as well as the rapid growth of French acquisitions in the U.S. Following the authorization of securitization in France at the end of 1988, French banks have specifically sought out U.S. securities firms as partners due to their long experience in this area. U.S. firms have served as managers of non-FF denominated stock or debt issues of French companies placed outside France. As the French look increasingly to foreign capital to help finance their investment plans, the need for internationally credible ratings for French firms has been recognized. Within the last two years, the two major U.S. rating agencies have entered the French market (one through an alliance with the single French rating agency) and account for a growing share of the ratings business.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Establishment/Entry: U.S. banks that want to do business in France must obtain a license from the Bank of France specifying the activities to be conducted. A banking license allows an institution to accept deposits and to engage in the full range of financial activities: commercial banking, securities activities, money market and foreign exchange operations, underwriting, portfolio management and investment advice. They have the choice of establishing as a branch or subsidiary, both of which require capital endowment separate from their parent firm. The application process and requirements for a U.S. or other foreign financial institution to obtain a banking license are identical to those for a French applicant. Likewise, U.S. or other foreign financial institutions applying for status from the Bank of France as a Maison de Titres are subject to the same requirements as a French firm.

The one area in the domain of entry where U.S. firms, financial or nonfinancial, face discriminatory treatment pertains to establishment through purchase of an existing French financial institution. French foreign direct investment procedures have been streamlined in recent years as a result of a U.S. effort to encourage more openness to foreign investors. Nonetheless, French regulations discriminate among French, EC, and non-EC firms. Specifically, most non-EC acquisitions of a French firm (defined as 20 percent of the shares for publicly quoted, one-third for non-quoted) are subject to an extendable one-month review period and can be denied or delayed for reasons of national interest. EC firms are only required to make an after-the-fact notification, or, at most, are subject to a maximum 15-day delay while their EC bonafides are verified. No U.S. investors have been denied since these rules were introduced in January 1990, but the implicit delay and uncertainty could put U.S. financial institutions at a disadvantage compared to their French and EC competitors in acquiring French financial institutions.

While French banking law contains no reciprocity requirements, French authorities can, in examining an application for a banking license, take into account the treatment accorded French financial institutions in the home country of the applicant. In this regard, the 1988 Annual Report of the Bank of France's Committee for Financial Institutions stated that it is French policy "to conform to their international commitments in according to foreign firms, notably EC firms, treatment in all aspects comparable to that applied to French firms. At the same time, the authorities are attentive that the French banks benefit from effective conditions of access and practice as satisfactory as possible in the home countries of those establishments wanting to set up in France, taking into account what France offers to the foreign establishments concerned." There is no evidence to suggest that any U.S. financial institutions have been denied entry on these grounds. On the contrary, there is evidence that French authorities have encouraged foreign and U.S. financial institutions to establish in France and have expressed regret that several U.S. banks have recently decided to close their Paris operations.

As noted previously, no new brokerage firms, foreign or domestic, will be permitted to be established as members of the Bourse until January 1992. Foreign and domestic firms, however, may participate by acquiring an existing member brokerage firm.

Operations: Once established in France, U.S. financial institutions engaged in securities activities are formally subject to the same legal and regulatory environment as French firms. In principle, all primary and secondary market activities are open to U.S. and foreign firms. In addition, with the final elimination of foreign exchange controls at the beginning of 1990, a major obstacle previously handicapping U.S. and other foreign firms has disappeared.

In practice, there appears to be only one activity from which U.S. (but not other foreign) firms are specifically excluded. U.S. firms are prohibited by government policy from acting as lead manager of public or private sector French franc domestic bond issues, though they participate in the syndicates. (Until July 1990, they could not lead manage EuroFF issues either. Two U.S. banks have subsequently been allowed to do so and others could be approved.) The French Government bars U.S. firms from this role since French commercial (i.e., universal) banks, due to Glass-Steagall, cannot underwrite, nor lead manage, bond issues in the United States if they are also engaged in commercial banking activities. As noted earlier, however, this ban does not apply to central government bonds issued by auction, which account for almost 30 percent of total new bond issues.

At the end of 1988, about 400 banks were licensed to operate in France, representing about FF5,300 billion ($874.7 billion) in assets. Of these, about 160 were foreign banks (accounting for 18 percent of assets), of which about fifteen were subsidiaries or branches of American banks. Because, as noted above, the French operate a universal banking system, which does not distinguish between investment and commercial banking activities, banks dominate French securities market activities. The primary focuses of American banks in France are corporate finance, wholesale banking and securities activities; only one U.S. bank has a retail banking network. As noted above, foreign banks generally receive national treatment.

CONCLUSION

Entry is easy and national treatment is accorded in almost all instances. French authorities are trying to attract foreign financial firms to France as part of a strategy to make Paris a major European financial center: foreign firms can now own French brokerages; 25 percent of members of the French futures market are foreign firms; and foreign firms are authorized primary dealers. With elimination of all foreign exchange controls and the comprehensive deregulation of financial markets, France has become a more attractive, albeit more competitive, financial marketplace. U.S. financial institutions can enter the French securities markets on the same conditions as French firms by establishing a subsidiary or a branch (dependent on U.S. laws). Procedurally, they are treated differently when making acquisitions, since non-EC firms (defined as firms controlled by non-EC entities) must receive prior approval from the Ministry of Finance. French authorities bar U.S. firms from lead managing domestic French franc bond issues, as a reciprocity protest against Glass-Steagall restrictions on French banks operating in the U.S.

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*U.S. dollar figures calculated at the following rates:

1985: $1 = FF8.9852 AA
1988: $1 = FF5.9569 AA; FF6.0590 YE
1989: $1 = FF6.3801 AA; FF5.7880 YE
1990: $1 = FF5.716 (June 1, 1990)

AA = Annual Average
YE = Year-End

37. Federal Republic of Germany - Securities

SUMMARY

The Federal Republic of Germany has a universal banking system which permits financial institutions to engage not only in traditional banking activities, but also in all aspects of the securities business. In fact, most securities activities in the FRG are considered to be a normal part of the "banking" business and, thus, both foreign-owned banks and securities firms are required to obtain a banking license from the Federal Banking Supervisory Office (unless they only intend to engage in business for their own account). Foreign-owned firms may enter the FRG securities market via branch, subsidiary, or by acquiring equity interest in existing institutions without restriction. The same terms and conditions apply for establishment of both foreign and domestic firms, although German authorities may apply reciprocity (but never have) with respect to establishment of a branch.

The securities market in Germany is characterized by the dominance of bond issuance and trading over equities business. Within the bond market, banks dominate as the primary issuer, but government bonds account for the majority of secondary market trading. The primary market is notable for the almost total lack of a corporate debt market, except the foreign DM bond market segment, and a relatively small corporate equities market, with German firms mostly relying on bank lending and their own funds for financing. Both bonds and stocks are traded on the FRG's eight regional exchanges, with Frankfurt being the leading exchange. A ninth computerized exchange (the DTB) was established in early 1990 for futures and options trading.

Over the years, the FRG federal government and the Bundesbank have encouraged measures to increase the attractiveness of Frankfurt and the Federal Republic as an international financial center. Since the last National Treatment Study in 1986, several significant developments have occurred. In 1987 and 1988, the stock exchanges were reorganized to ease listing requirements for smaller firms, and nonresidents were permitted to purchase federal five-year notes, respectively. In 1989, notification requirements on the issue of foreign DM bonds were dropped, the maturity period was shortened, and the Stock Exchange Law was amended to provide the basis for futures and options trading (the DTB exchange began trading in January 1990). Finally, in 1990, the Bundesbank permitted the domestic issuance of debt instruments denominated in foreign currencies, and the Financial Market Promotion Act was passed, which abolishes two capital market taxes, the securities transaction tax (effective January 1, 1991) and the company tax (effective January 1, 1992), and which permits investment funds to trade in futures.

The financial market in the Federal Republic of Germany has the reputation of being one of the most open and liberal in the world. Nevertheless, foreign-owned financial institutions have found it difficult institutionally to break into the market and expand business. Foreign-owned banks account for only five percent of all on-balance sheet business. The largest foreign-owned bank in the FRG ranks only 54th in the country by assets, even when both its subsidiaries are combined. The Federal Banking Supervisory Office believes that the foreign businesses would be larger if assets were not booked outside the FRG to avoid minimum reserve requirements and lending limits. Nevertheless, in some areas, the foreign-owned banks do quite well. They account for about 20-25 percent of DM-bond underwriting and about 60 percent of trading in futures and covered warrants.

Although market penetration difficulties are due primarily to institutional, cultural, and historical reasons, U.S.-owned financial firms have noted several impediments which deny them opportunities to compete equally with German firms in the securities business. In particular, several measures contribute to make the entry and operation of a branch of a foreign financial institution a less attractive choice. First, lending limits for branches of foreign banks are based on the net worth of the branch, rather than on the parent's capital, even though direct branches in the FRG are not legally independent of the parents. Second, branches may not participate in the federal bond consortium for the underwriting of long-term federal bonds and may not lead manage foreign DM bond issues. Third, even though branches are not legal entities in the FRG, they are required to maintain and process all original records within the FRG, rather than consolidate them with the records of their parents or other affiliates.

Foreign-owned subsidiaries face essentially no discrimination. They may be subject to an informal reciprocity consideration in the lead management of foreign DM bond issues, but this has never been used against

U.S.-owned firms. Previous restrictions on the foreign banks' share within the federal bond consortium for the underwriting of long-term government bonds have been eased due to the implementation of the auction technique as of August 1990.

German financial market issues have been raised in various discussions between the U.S. Treasury and the German Finance Ministry. Entry into FRG markets is not restricted and foreign institutions generally are treated comparably to local firms, although in practice, increasing market penetration is difficult to achieve.

OVERVIEW

Domestic Securities Markets

According to the Federation of German Stock Exchanges, the securities market in the FRG is ranked as the fourth largest in the world, behind Japan, the U.S., and the U.K., with total annual turnover in equity and debt of DM 3.29 trillion ($1.9 trillion)* end-1989. By listing, the FRG ranked fifth in the world (behind Canada), with 1,163 domestic and foreign companies listed on all the German exchanges. By capitalization, the FRG also ranked fifth, with a market value of DM 620 billion ($365.2 billion) for the equities of 628 domestic companies listed.

The Primary Markets

Equities: In the primary markets, new equity financing reached DM 39 billion ($20.7 billion) in 1989, only one-third of the amount of new debt financing. According to the Federation of German Stock Exchanges, domestic and foreign issuers were split about evenly. The number of domestic companies whose shares are listed on the FRG exchanges totalled 628 in the 1989, ranking Germany sixth in the world, behind France. The lack of supply accounts for part of the reason. For historical reasons, most German firms have been small to medium-sized and family owned. In addition, management and accounting flexibility have encouraged the creation of about 400,000 privately limited companies (GmbHs) in the FRG, whose ownership is in private hands and whose shares are not tradeable.

Only the shares of the 2,500 stock corporations (AGs) can be traded. Nevertheless, for a number of reasons, only one-fourth of the stock corporations are listed on the German stock exchanges. First, listing costs tend to be high. Bank charges, prospectus, publication costs, and a fixed listing commission can reportedly run from 5 to 9 percent of the value of the shares issued. In addition, the company tax (Gesellschaftsteuer) of one percent is assessed on all new and supplemental share issues (although the tax will be repealed January 1, 1992).

A firm also faces some lack of flexibility in offering an issue. Under German corporate law, a capital increase via an equity issue, including the terms and conditions of the issue, requires a three-fourths approval at the annual shareholders meeting. In addition, existing stockholders have "preemptive rights" to a new issue, i.e., they have the exclusive right, waived only by three-fourths majority vote at the shareholders' meeting, to buy up to all the shares of a new issue at below market rates. The domestic underwriting syndicates, which are long established and traditionally oriented, are also not conducive to innovative and perhaps more competitive, cheaper equity financing techniques. New institutions applying for membership and a quota in the syndicate must first represent existing shareholders and then receive approval from the issuing firm and lead manager. Finally, a strong "house" bank concept, whereby a firm relies on one universal bank for its financial advice and its financing needs, offers the firm the alternative of direct lending.

The absence of invested pension funds also accounts for lower demand for equities. The federal pension system is a "pay as you go" system, with minimal reserves and even less invested in securities. Private pension funds, according to some estimates totalling as much as DM 300 billion ($177.1 billion), are mostly kept on the books of firms for their own use rather than as investments in securities. There may also be relatively less demand for shares with voting right restrictions and shares with multiple/no voting rights attached.

Corporate Debt: In contrast to equity financing, new debt securities financing in 1989 totalled almost DM 120 billion ($63.8 billion), with domestic issuers, mostly banks, accounting for two-thirds. Domestic corporate debt financing (via the so-called "industrial bond"), however, in what is a distinctive characteristic of the German bond market, has been practically nonexistent (less than 0.3 percent in 1989), due to several factors. First, firms have access to other financing. Firms can rely on a "house bank" for lending. In the last several years, firms have also been cash rich, financing as much as 95 percent of investment out of their own funds, although the capital demands for investment in the former German Democratic Republic (GDR) and Eastern Europe will undoubtedly change this.

Second, firms have access to a different type of debt instrument, a "loan against borrowers' notes" (Schuldscheindarlehen). These notes are privately placed by banks with institutional investors, have customized terms, and are cheaper to issue (as little as 0.5 percent of issue compared to up to 3 percent for industrial bonds), since a prospectus, underwriting syndicate, and an exchange listing are not needed. Most importantly, since these notes are not considered debt securities under German law, they do not have to be marked to market when interest rates rise, and thus are attractive to investment portfolios for their stable values.

Finally, under paragraphs 795 and 808a of the German Civil Code, domestic German firms are required to obtain approval from the Finance Ministry before issuing most debt securities, reducing somewhat their timing flexibility. A bill repealing this provision is currently being considered by parliament (Bundestag), with passage expected soon. German firms may circumvent this procedure if they raise funds through their foreign subsidiaries by use of foreign DM bonds. In fact, this has had an important impact on the issue of foreign bonds in the FRG, which totalled over DM 40 billion ($21.3 billion) in 1989, or one-third of all issues.

Government Debt: The federal government has a large array of debt instruments and debt financing techniques available to it. The current most important instruments are the Federal Bonds ("Bundesanleihen"), Treasury Financing Paper ("Finanzierungsschaetze"), and Five-Year Special Notes ("Bundesobligationen"). Other instruments include Medium-term Notes ("Bundesschatzanweisung"), Treasury Discount Paper ("U-Schaetze"), Federal Savings Bonds ("Bundesschatzbrief"), and negotiable loan agreements ("Schuldscheine"). The government uses a syndicate, auction, tap, open market sales and private placement as financing techniques.

Federal bonds ("Bundesanleihen" or "Bunds") are the most important debt instrument of the federal government, with a net issue of DM 24 billion ($12.8 billion) in 1989 (after redemptions and expiring debt). In the past, the Bunds had been issued strictly via a syndicate, about eight times per year and usually with a maturity of ten years and in amounts ranging up to DM 6 billion ($3.5 billion) per issue. An auction method was first used early in 1990 for special floating rate note issues of the federal government, federal railway, and the postal service, and in August 1990 for fixed rate issues. The procedure now used for issuing federal bonds is a three tranche method: fixed quota consortium method; auction; and a market tending portion for the Bundesbank.

The underwriting syndicate for Bunds used for the first tranche consists of 110 banks (including 49 foreign-owned) and is lead managed by the Bundesbank, which generally retains a portion of an issue -- historically about 20 percent -- for price support functions. Acting as agent for the Ministry of Finance, the Bundesbank selects the members and determines an allocation quota for each member and an aggregate quota of 20 percent for all foreign-owned members. To be eligible for membership, a bank must be a legal entity under German law, belong to a stock exchange, have the capacity to place bonds with long-term investors, and be willing to accept the terms for each issue. Each consortium member receives an underwriting and selling commission of 7/8 percent of their portion of the issue to cover expenses and risks.

Under the second tranche, which is the auction method, consortium member banks are free to bid as much as they would like and thus are free of the quota restrictions under the first tranche. Experience with the new auction system for fixed rate debt has been limited since the new method has only been in place since August 1990. However, as of October 1990, the new system had been used successfully, except for one instance involving a German Unity Bond issue, where the Finance Ministry cancelled the auction due to unfavorable market conditions.

In the past, the Bundesbank used a "bondification" system to encourage members to place the bonds with long-term investors. Each individual bond was assigned a control number, and if the Bundesbank acquired a bond (excluding "free" bonds originally retained by the Bundesbank for open market operations) in the secondary market at or below the original issue price before the one year anniversary of the original issue, the member bank which placed the bond was penalized. However, the procedure has now been discontinued.

Treasury Financing Paper ("Finanzierungsschaetze") was a popular financing technique in 1989, with a net DM 6.4 billion ($3.4 billion) issued, compared to only DM 1.5 billion ($0.8 billion) outstanding at the end of 1988. The paper is issued on tap on a discounted basis, for one or two year maturities. It is sold in small denominations of DM 1,000 ($590) geared to individual resident investors (credit institutions and nonresidents are not permitted to purchase the paper). A related short-term instrument, with a maturity of six months to two years, is Treasury Discount Paper ("Unverzinsliche Schatzanweisungen" or "U-Schaetze" for short), but the paper carries a higher denomination, DM 100,000 ($59,000), and is issued by Dutch auction, open market sales and private placement. In addition, banks are allowed to purchase the paper.

Medium-term Notes ("Bundesschatzanweisung"), Five-year Special Notes ("Bundesobligationen") and Federal Savings Bonds ("Bundesschatzbrief") have slightly longer maturities. Medium-term notes are issued for three to almost six years, with four years most common. Nonresidents may place bids through residents only. The notes are distributed via Dutch auction and private placement, but in 1989 their importance diminished. The Five-year Special Notes, with a denomination of only DM 100 ($59), are geared to individuals and nonprofit organizations (including, since October 1988, foreigners and credit institutions). They continue to be popular, and DM 4.2 billion ($2.2 billion) were issued on tap in 1989. Federal Savings Bonds are issued in either six or seven year maturities to residents only and are nontradeable.

Finally, negotiable loan agreements ("Schuldscheine") are worth more detailed discussion. This instrument, similar to its corporate counterpart, is an arrangement between the Ministry of Finance as the issuer, and a lender, usually a commercial bank or insurance company, for a direct loan to the federal government in exchange for a promissory note. The Bundesbank is not involved in the deal. The loan carries a fixed interest rate, and since it is not treated as a security under German law, it does not have to be marked to market when interest rates rise. It can be customized to the lender with a maturity ranging from one to 15 years, with 5-10 years the most common. It can be denominated in amounts of from DM 1 million ($590,000) to over DM 100 million ($59.0 million).

The promissory note can be traded in the secondary market (though it is not listed on the exchanges), but is normally limited to three resales and is registered in the name of the buyer. Since the mid-1980s, with the elimination of a tax advantage and falling interest rates, this debt financing technique has not been used as much by the federal government, although the state and local governments still use this instrument quite extensively.

The Secondary Markets

Equities: In the secondary markets, equity trading has traditionally accounted for only a small share of total trading on the exchanges; in 1988, equity turnover totalled DM 716 billion ($407.7 billion), less than 30 percent of total turnover. However, beginning in June 1989, trading picked up substantially, influenced by the Eastern Europe euphoria, and turnover totalled almost DM 1.4 trillion ($744.7 billion) for 1989, about double the volume of the year before, and increasing the share to over 40 percent of total trading. Nevertheless, some observers believe that London's International Stock Exchange still sees an equivalent of a third of turnover in German blue chips (a statistic disputed by the German exchanges).

Several tax considerations have discouraged equity trading relative to bond trading. First, shares which are held less than six months are subject to a capital gains tax, which does not apply to fixed-income securities. Second, a securities transactions tax ("Boersenumsatzsteuer") is applied to secondary market trading (until January 1, 1991), and generally, at a higher rate for equities than for debt. A tax rate of 0.25 percent applies to all shares, foreign DM bonds and corporate debt, although the market for the latter is basically nonexistent; a lower rate of 0.1 percent applies to municipal and mortgage bonds; bonds of the federal government and, usually, states are exempt. Finally, dividends from equities are subject to a 25 percent withholding tax. A ten percent withholding tax on interest earnings, including from bonds, was in effect for the first six months of 1989, but the political opposition was so great that it was scrapped.

Debt: Government debt accounts for the overwhelming share of the total secondary market trading on the exchanges in debt securities. Total trading amounted to almost DM 2 trillion ($1.1 trillion) in 1989, of which 90 percent was accounted for by trading in bonds of the federal government and agencies. Foreign DM bonds accounted for five percent of the total. Bank bonds, although accounting for 45 percent of primary debt issuing in the FRG in 1989, amounted to less than one percent of secondary market trading, with the bonds remaining in investor portfolios. Trading in domestic corporate debt was practically nonexistent, with supply continuing to be discouraged by issuing restrictions.

Options and Futures Market: The options and futures market in the FRG is still in an embryonic stage. Until 1988, futures and options trading was legally treated as gambling. Under the gaming provisions of the German Civil Code (paragraphs 762 and 764), individual investors who took a loss on an options or futures activity had the right to declare such contracts nonbinding, leaving the dealer to absorb the loss. In addition, under the forward trading provisions of the Stock Exchange Law (paragraph 5264), a forward contract was nullified unless the parties to the transactions were either nonresidents, professional traders or registered dealers. Thus, no regular futures trading existed and although professional trading in options on shares and bonds began in 1970 and 1986, respectively, the market was essentially nonexistent.

The market response to these restrictions was the offshore development of options and futures trading in Deutsche Mark instruments. In September 1988, the London International Financial Futures Exchange (LIFFE) introduced, with considerable success, a futures contract for ten-year German bonds, with the corresponding option in April 1989. Also in April 1989, LIFFE and MATIF, the French financial futures markets, both introduced three-month Euro-DM interest rate futures, with the corresponding option in March 1990. The ability to hedge against risk in the cash market in Frankfurt has created large demand and volume in both offshore markets which has exceeded all expectations.

On August 1, 1989, amendments to the Stock Exchange Law took effect, which laid the legal foundation for futures trading. Under the new law, a financial futures contract is considered enforceable if one party is a merchant trader and the other party has agreed in writing to recognize the risks involved in futures trading. However, commodities futures trading (other than precious metals) is not protected by the new law.

In anticipation of the legal changes, a group of 17 financial institutions representing commercial, regional, private, savings and cooperative banks in Germany, founded the German Options and Futures Exchange (Deutsche

Terminboerse or DTB) in July 1988. On January 26, 1990, the DTB started official trading. The DTB is a computerized on-line trading system which, while located in Frankfurt, is accessible country-wide for orders and execution. The exchange is open for business beginning 10:30 a.m., concurrent with the Frankfurt Stock Exchange, and closes at 3:00 p.m. Currently, only options can be traded, those on 15 leading German blue chip stocks. The results have been better than expected and about 25,000 contracts are being traded per day with very few problems. Late in 1990, the DTB intends to introduce a futures contract on a notional Bund with a remaining maturity of 8-1/2 to 10 years to compete directly with LIFFE and a futures contract on the real-time German Stock Index (DAX).

Fifty-three financial institutions are currently members of the DTB. For trading purposes, there are two classes of membership: ordinary brokers, who execute orders for their own account and for clients; and market makers, who provide firm buying and selling prices on a continuing basis for a particular contract. At the start of the DTB, there were 24 market makers. For clearing and settlement purposes, there are three classes of membership: General Clearing Members (GCMs), who may clear their own and other transactions; Direct Clearing Members (DCM), who may only clear their own transactions; and nonclearing members, who clear through GCMs. At the start of the DTB, there were 46 GCMs and DCMs. Subsidiaries of foreign banks are eligible for membership in the DTB on the same terms as domestic banks. A number have joined, and one foreign-owned bank is represented on the Board of Managing Directors. However, foreign-owned banks have found the equity requirements of DM 250 million ($177.1 million) to become GCMs rather high, opting instead to become DCMs, which have equity requirements of DM 25 million ($14.8 million).

Structure/Regulation: In addition to the DTB for options and futures trading, there are eight regional exchanges for equities and debt in the FRG, located in Frankfurt, Duesseldorf, Munich, Hamburg, Stuttgart, Berlin, Hannover and Bremen. Frankfurt is by far the largest, accounting for two-thirds of all FRG turnover in 1989 (down somewhat from its 71 percent share in 1988). In bonds alone, Frankfurt accounted for three-fourths of all trading. Duesseldorf was the second most important exchange, accounting for 18 percent of all FRG trading in 1989. In July 1986, the eight exchanges founded the Federation of German Stock Exchanges to coordinate their activities, strengthen their competitiveness and represent their interests.

There is no equivalent of the U.S. Securities and Exchange Commission in the FRG to regulate the entire securities market. The German exchanges themselves are subject to the 1896 Stock Exchange Law, as amended, and (along with the German Options and Futures Exchange) are broadly regulated by the Ministry of Economics in the state in which they are located. For day-to-day management, the eight exchanges are self-regulatory organizations. Seven of the eight are under the auspices of the local chamber of commerce or a private association, while the Frankfurt Stock Exchange decided to be reorganized as a stock corporation. The board of directors of an exchange supervises the members admitted to trading. In addition, the Federal Banking Supervisory Office regulates all FRG banks, including those admitted to exchange trading.

There are three classes of members allowed to trade on the eight regional exchanges: representatives of banks; official brokers; and unofficial brokers. The largest category is the bank representative ("Haendler" or Trader). Traders execute orders, usually through brokers, on behalf of clients or on their own account. Official brokers ("Amtliche Kursmakler") do not deal directly with the public, but arrange transactions in officially listed securities assigned to them and establish or fix official quotations. They cannot normally trade for their own account. Unofficial brokers ("Freier Makler") do not participate in the price fixings of officially listed securities, but may deal in officially or unofficially listed securities and may trade for their own account.

The eight exchanges operate from 10:30 a.m. until 1:30 p.m. each day. Outside of these hours is off-exchange trading, including a large over-the-counter market mostly among banks, statistics for which are not collected. The exchanges are now organized into a three-tiered structure: the official market; the regulated market; and the free market. The official market ("Amtlicher Handel") is by far the largest segment, accounting for 80 percent of all securities listed on the eight exchanges and has the most stringent listing requirements. The appropriate official broker fixes the price of each security once a day, usually around noon, at which time trades are conducted. If necessary for federal bonds, the Bundesbank conducts price support operations. Since October 1988, certain high-volume bonds can be priced and traded continuously throughout the business hours.

The regulated market ("Geregelter Markt"), established in 1987 during the restructuring of the exchanges, is geared to small and medium-sized companies with about 15 percent of the securities listed and has less stringent listing requirements. Finally, securities, especially those of smaller companies, which do not meet the admission requirements of the first two segments are admitted to the free market ("Freiverkehr").

With the exception of DTB, trading is not conducted electronically on the exchanges. Several screen-based information systems, which at this time display only prices, have been established to pave the way ultimately for computerized trading. The most important is the Inter-Bank Information System (IBIS), founded by the banks in December 1989, which provides continuous prices for the 14 stocks whose options are traded on the DTB. Not to be outdone by the banks, the official brokers also started MATIS ("Makler TeleInformation System") in December 1989, which has a larger listing of prices. Finally, the unofficial brokers also announced their own system, MIDAS, for implementation later in 1990.

The development of screen-based pricing systems has created considerable controversy among the various players in the German securities market. The official and unofficial brokers are concerned that the conversion of IBIS into a computerized trading system could eliminate their jobs. The exchanges outside of Frankfurt are also concerned that the use of the nationwide IBIS system as a new exchange could undermine the usefulness of the regional exchanges. Finally, the Bundesbank and the Federation of German Stock Exchanges have not hidden their desire for a merger of all three information systems, and discussions are currently underway between the banks and official brokers.

Progress Since 1986: The last National Treatment Study Update, issued in December 1986, discussed the so-called "Residual Liberalization" measures announced by the Bundesbank in 1985. Under the announcement, German subsidiaries of foreign financial institutions could for the first time lead manage foreign DM bond issues. In addition, several new instruments were allowed: floating rate notes, zero coupon bonds, swaps and multiple-issues. Finally, in 1986, the Bundesbank also permitted DM CDs and opened the federal bond consortium to new foreign-owned members.

Since 1986, the government, the Bundesbank and financial market players have continued the process of financial market liberalization beyond the "residual" measures, motivated by a desire to strengthen "Finanzplatz Deutschland," i.e., the attractiveness of Germany as a major financial center.

On May 1, 1987, the new Stock Exchange Admission Act went into effect, codifying the "regulated market segment" (Geregelter Markt) and reorganizing the structure of the exchanges. On August 1, the Bundesbank announced a further reduced notification period for new issues of foreign DM bonds (from two weeks to two days), effective immediately. On October 3, 1988, the Finance Ministry permitted foreign individuals to purchase federal five-year special notes ("Bundesobligation") on the primary market (which was formerly available only to domestic individuals and nonprofit organizations), effective immediately.

Beginning in 1989, developments started to accelerate. First, in June, Bundesbank President Karl Otto Poehl gave a historic speech proclaiming his desire to strengthen the financial attractiveness of the FRG, i.e., "Finanzplatz Deutschland." President Poehl stated that "further measures (in addition to the 1985 residual liberalization and establishment of a futures market) will have to be taken to ensure that the German financial market does not drop even further behind." He said that the "federal government's issuing techniques should be reviewed and systematically brought into line with present-day trading practices." He criticized the current industrial bond issuing authorization practice as no longer making sense and called for early abolition of the securities transaction tax. Finally, President Poehl concluded that the market for equities should be made more attractive and that voting right restrictions and maximum voting rights did not help.

President Poehl's speech was likely motivated by the Bundesbank's "Anchoring Principle," whereby all DM securities business should be "anchored" in the FRG to give the Bundesbank greater monetary policy control, and by the Bundesbank's desire to strengthen Frankfurt as the German financial center. He called for centralization of the eight exchanges and strengthening the Frankfurt Exchange. In his speech, President Poehl hinted at Frankfurt as the location of a European central bank and later made this suggestion more explicit. Finance Minister Waigel formally proposed Frankfurt as the site for the "Euro-Fed" at the April 1990 EC summit in Dublin.

Most of the measures called for in President Poehl's June 1989 speech have been methodically implemented. As noted in the speech, the Bundesbank announced July 1, 1989 that the issue of foreign DM bonds would no longer require prior notification, and henceforth the minimum maturity for public and privately placed foreign DM bonds would be reduced to two years. Amendments to the Stock Exchange Law took effect August 1, 1989, providing the basis for futures and options trading in the FRG (which began January 26, 1990), and permitting listing of foreign currency denominated securities on the exchanges. On January 5, 1990, the Bundesbank announced that the issue of debt instruments denominated in foreign currencies, ECUs and SDRs would be permitted in the FRG, effective immediately.

While not specifically addressed in President Poehl's speech, the Bundesbank nevertheless removed a "blemish" in September 1989, by reducing or eliminating certain special discount lines primarily used to support regional and trade financing: (1) the AKA, a private export credit company owned by a consortium of commercial banks, will have its preferential DM 4 billion ($2.4 billion) line of credit at the Bundesbank cut in half by end-1990; (2) privatdiskont AG, a private company owned by German banks, will have its DM 3 billion ($1.8 billion) rediscount facility at the Bundesbank, which is below market interest rates, eliminated by end-1991; and (3) the KfW or Reconstruction Loan Corporation, a publicly owned bank which finances regional projects and exports, will have its DM 1 billion ($590.5 million) line of credit eliminated by end-1990.

Finally, several pieces of pending legislation were combined into the "Financial Market Promotion Act", which took effect March 1, 1990. The long criticized securities transaction tax (Boersenumsatzsteuer) will finally be abolished, effective January 1, 1991. The company tax (Gesellschaftsteuer) and the bill of exchange tax (wechselsteuer) will also be abolished, both effective January 1, 1992. In addition, FRG law was harmonized with the EC Mutual Funds Directive to permit more investment opportunities for mutual funds, and investment funds were allowed to trade on the futures markets, expected to provide the DTB with an increased source of funds.

In May 1990, the Bundesbank concurred with changes to capital standards proposed by the Federal Banking Supervisory Office, effective October 1, 1990. The changes to Principle 1 ("Grundsatz 1") recognize new financial instruments for regulating credit risk. However, the changes to Principle 1A ("Grundsatz 1A") anticipate discussion currently taking place in the EC and BIS for regulating market risk. Financial firms operating in the FRG will be required to limit open positions in relation to capital in off-balance sheet items in the securities area, including swaps, option, and futures. Thus, in contrast with other financial market measures to date, this change will have the effect of raising costs and dampening the attractiveness of "Finanzplatz Deutschland," at least until other countries adopt similar requirements. Nevertheless, the Finance Ministry believes it important enough for policy reasons to support the safety and soundness of banks even if it is a temporary disadvantage for "Finanzplatx Deutschland." Foreign-owned firms, including U.S. securities firms, which tend to specialize and have a comparative advantage in these off-balance sheet items will especially find their relative costs higher.

A number of important issues key to the development of "Finanzplatz Deutschland" are still outstanding. The bill to eliminate the "Paragraph 795" approval requirements for the issue of corporate bonds is still pending in the Bundesrat (upper house). Despite considerable discussion, pure money market funds will not be allowed in the near future (and the Bundesbank has no public plans to eliminate the minimum reserve requirements). Other developments on the horizon include computerization of securities trading, in addition to options and futures trading. The Federation of German Stock Exchanges is also participating in a European-wide information linkup, the Price Information Project Europe (PIPE). The approval of EC directives in financial services and the corresponding harmonization of FRG law is likely to have a major impact.

Finally, the agreement between the FRG and the former German Democratic Republic to form the German Economic and Monetary Union (GEMU) on July 1, 1990, as well as the subsequent political unification on October 3, 1990, brings about numerous changes and offers many opportunities in the financial markets. When the GEMU took effect, the Federal Banking Supervisory Office and the Bundesbank extended their sovereignty into the former GDR, offering a larger market to foreign financial firms. In addition, most of the 8,000 former GDR publicly owned firms are in the process of being privatized, creating opportunities in the underwriting and the merger and acquisitions business. To our knowledge, all statutory and regulatory changes resulting from the German unification process are in accordance with the equality of competitive opportunity.

U.S. Presence in the Market

Under the universal banking system, there is no distinction between the banking business and the securities business. Foreign firms wishing to engage in most securities activities must register as a bank. According to Bundesbank statistics, there were 162 foreign banks in the FRG at end-1989, 60 of which were bank branches and 102 were subsidiaries. According to the Foreign Bankers' Association, the EC represented the largest group of foreign-owned financial institutions with 47 firms, followed by the U.S. with 33 firms, and Japan with 27 firms.

Of the 33 U.S. banks in the FRG at the end of 1989, 22 were subsidiaries and 11 were branches. Because of overlap, there were only 23 U.S. parents represented, with the status in the United States as follows: 14 banks; 4 securities firms; 3 commercial or industrial companies; and 2 other. In addition, 13 U.S. firms, including five securities firms, had representative offices in the FRG.

The foreign banks' market share has remained rather modest in the FRG, about five percent of the on-balance sheet business. U.S. banks' market share has been below two percent. The largest foreign-owned bank, which also happens to be a U.S.-owned bank, ranks only number 54 (end-1988) among all German banks, based on the combined balance sheet of its two subsidiaries, according to statistics from both the German and the Foreign Bankers' Associations. Excluding public savings and cooperative banks, the foreign share is 20 percent of all commercial banks' on-balance sheet business. While statistics are not readily available, if off-balance sheet items such as foreign exchange, interest rate and currency swaps, options and now futures were included, the share of foreign-owned banks would be higher. However, as an example of the interest futures business, U.S.-owned banks held a 60 percent share of the market.

Foreign-owned banks have been relatively more active in the debt markets. According to the Bundesbank, foreign banks accounted for about 20 percent by volume (1989) of all lead management of DM bond underwriting. Of the 120 banks in the federal bond consortium, 49 are foreign-owned. Their share of activity in the secondary market has reportedly exceeded 20 percent.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Establishment/Entry: Procedures for entry and establishment have remained unchanged since the last National Treatment Study Update. Under Germany's universal banking system, U.S.-type securities market activities are considered to be banking activities. Any firm wishing to engage in such activities must first secure a banking license from the Federal Banking Supervisory Office (FBSO). The license application procedure and approval criteria for foreign applicants are essentially identical to those for domestic applicants. Foreign securities firms may also apply for less comprehensive licenses limiting them to trading securities strictly for their own account, as opposed to banking and other securities activities. Entry may occur through establishment of a branch or subsidiary or acquisition of an existing institution. Representative offices are also allowed and require only notification.

Since 1985, the Banking Act has allowed the FBSO to refuse a banking license to a direct branch of a non-EC bank if "reciprocity on the basis of international agreements is not assured." No unequivocal definition of reciprocity has been given, and this provision has never been used. The provision does not apply to licenses for subsidiaries.

Recently, some U.S. financial firms have been frustrated by the approval procedures for adding senior management from the United States. The FBSO requires all members of the Board of Managing Directors (Vorstand) of the firm in Germany to demonstrate sufficient German language skills. While such a requirement is not discriminatory per se -- although some would argue that German language for only a majority of members should be sufficient -- there have been some complaints that the FBSO is subjective in its review -- strongly denied by the FBSO. In addition, some U.S. securities firms have noted that credit experience is necessary for Board members, which makes it difficult to draw upon the U.S. parent for personnel who have only been active in the securities and not the credit business. The FBSO and Bundesbank argue that the requirement is necessary since securities firms normally have full banking licenses.

Operations: U.S.-owned financial firms generally receive treatment as favorable as that accorded to German firms. German authorities do not maintain regulations which explicitly discriminate against foreign-owned firms.

Possession of a full banking license entitles the holder to engage in the full range of approved securities activities, with all holders subject to virtually identical regulatory treatment.

Nevertheless, there are a number of areas in which, while legal treatment may be identical, U.S. banks do not have the same opportunities to compete as German banks. Because of the universal banking system, it is difficult to separate the securities business from the banking business, and lack of opportunities in the latter can affect the former, so both types of activities will be considered. The two main problems areas for U.S. financial firms are: branch lending and lead-management restrictions; and cross-border data processing restrictions.

After a branch of a foreign bank is licensed to operate in the FRG, it is required to meet certain capital requirements for prudential reasons. The capital required of a branch is composed of operating capital placed by the parent bank at the disposal of the branch (so-called "dotation" or endowment capital), plus operating surpluses retained by the branch. The dotation capital requirement is similar to the capital equivalency deposit (CED) concept used in the United States. The FRG then imposes the same lending limitations and other capital adequacy requirements on the branch capital as on the capital of foreign bank subsidiaries and domestic banks (e.g., no single loan can exceed 50 percent of capital, aggregate loans may not exceed 15 times capital, etc.).

Nevertheless, U.S. banks have two concerns with these branch capital requirements. First, in contrast with the CED concept in the United States, the lending limitations are not based on parent capital; they apply only to the dotation capital of the branch. Thus, a branch which is legally dependent on its parent is unable to make loans of a size commensurate with the parent bank's capital in its lending business, which reduces the attractiveness of a branch as a method of entry. Both the Bundesbank and Finance Ministry argue that the regulation is necessary for prudential reasons, since a customer can borrow from both the parent and branch simultaneously.

The second concern by U.S. banks is prospective. The EC Second Banking Directive requires the FRG, effective January 1, 1993, to eliminate completely the dotation capital requirement for direct branches of EC-based banks. However, currently the FRG intends to maintain the requirement for non-EC based banks, thus discriminating on the basis of nationality. Although a U.S. bank could circumvent this requirement by establishing a subsidiary in an EC country to obtain the "EC passport," the capital of the subsidiary limits its lending and offsets the advantages of a branch. Therefore, those U.S. banks which prefer to maintain direct branches out of the United States into Germany for business reasons will not have the same opportunities to compete as, for example, a U.K.-owned bank which branches directly into Germany. The Finance Ministry recognizes that this could be a problem for U.S. banks, but would rather see how the 1992 process works itself out. The Bundesbank notes that further regulatory harmonization among countries could eliminate the problem.

Although branches of foreign banks may establish, be licensed, and generally operate on the same basis as other bank entities in the FRG, there is one significant area in which they are restricted, lead management. Foreign bank branches may not participate in the federal bond consortium which underwrites federal long-term bonds. They also may not lead manage foreign DM bond issues in the FRG (although co-leading is permissible). The Bundesbank argues that these two restrictions are in place because of the FRG's "anchoring principle," viz., the policy that all issues must be lead managed by a legally established, independent entity in the FRG and listed on a German exchange (before listing on a non-German exchange) to "anchor" the issue in the FRG. The Bundesbank states that this is part of its regulatory philosophy and is an alternative to the extensive list of regulations required by other countries to issue in their own markets.

Subsidiaries of foreign banks face no such prohibitions on lead management. However, when the Bundesbank first permitted lead management of foreign DM bond issues in May 1985, it reserved the right to apply a reciprocity guideline to financial institutions whose home country does not permit "similar possibilities" (i.e., lead management privileges) to German banks. The guideline is similar in concept to the U.S. Primary Dealer Provision in the 1988 Omnibus Trade Act (regarding the U.S. government primary debt market), but is not specified in statute or regulation. The FRG authorities applied this provision once to Japanese firms, but it has not been used against U.S. firms.

The other major area in which U.S. bank branches and subsidiaries have not had the same opportunities to compete is in the area of cross-border data processing. In a

December 1982 interpretation of the Banking Act, the Federal Banking Supervisory Office (FBSO) stated that in order to examine the business operations of a credit institution at any time "originals of all books and documents which are part of the bookkeeping system must be kept within the territory of the Federal Republic of Germany." Furthermore, the FBSO requires that the data, storage medium, software and hardware must all be located in the FRG.

In 1989, a number of U.S. banks appealed this decision to the Federal Banking Supervisory Office, proposing instead that while the original books could be kept in the FRG, the physical data processing should be allowed in other countries using duplicate books in order to combine their international data processing requirements in a more efficient manner. The FBSO denied the appeal, arguing that for auditing purposes it had to be necessary to inspect all aspects of the bookkeeping within the FRG. The FBSO applies this requirement equally to German and foreign-owned banks so that in a strict legal sense there is no discrimination. Nevertheless, foreign-owned banks do face a distinct cost disadvantage vis-a-vis German banks. By nature, foreign bank operations in the FRG are smaller and the requirement prevents them from combining their data processing operations in the FRG with those in other countries. German banks, on the other hand, may combine such operations since their head office is in the FRG.

In June 1990, the Foreign Bankers Association once more appealed the decision, arguing that recent improvements in computer technology should obviate the need for on-site hardware inspection, while still maintaining the requisite regulatory standards of the FBSO. The matter is again under review by the FBSO. However, this time the FBSO has acknowledged that the regulation does result in a cost disadvantage to foreign banks. The FBSO is considering alternative solutions to the problem, with a decision expected by the end of December, but at this time is unable to state how the matter will be resolved.

A major problem faced by U.S. firms was addressed by the government in August 1990. Subsidiaries of foreign banks used to face restrictions in the German government primary debt market. As discussed above, federal bonds or Bunds were issued strictly by a syndicate, the federal bond consortium. Within the syndicate, the Bundesbank assigned the 45 foreign-owned banks an aggregate quota of 20 percent, and the 61 German-owned banks 80 percent of an issue. Although individual quotas were not made public, it was generally known in the market that foreign-owned members had individual quotas ranging from 0.25 percent to 1.5 percent, whereas the big three German banks had a total share of 29 percent. The Bundesbank assigned the quotas based on the notion of long-term placement capacity measured over an extended period of time. The quotas were last revised in 1986.

However, although the fixed-quota consortium method is still used for the first tranche of an issue, in the second tranche of the bond issue, i.e., the auction, foreign banks are free to bid as much as they want. The continued availability of this second tranche would substantially resolve the problem faced by foreign firms in this market.

Another debt financing technique used in the FRG government primary debt market is the Schuldscheine (negotiable loan agreement). The use of the Schuldscheine is similar in concept to a private placement, and when such a technique is used by a public body, the possibility for abuse could arise, in terms of lack of transparency for the debt issuance and potential problems for access by foreign firms to this market. However, the German government believes the procedure to be very open and transparent, and U.S. firms have not had any national treatment complaints. In any event, U.S.-owned financial institutions have not found the placement and trading of this instrument to be very attractive, partially due to its lack of liquidity in the market, and given the current reduction in usage by the German Federal Government.

Domestic Banking Market

At the end of 1989, over 4,200 banks with more than 44,000 offices were present in the Federal Republic of Germany and had total assets of DM 4.2 trillion ($2.5 trillion). Local government-owned savings banks, with 37 percent of the assets, account for the largest sector of the German banking system; private commercial banks are the next largest with about one-fourth of all assets; credit cooperatives hold 16 percent; and miscellaneous specialist banks, 22 percent. Foreign-owned banks, both subsidiaries and branches, number 162 (end-1989) and hold slightly over 5 percent of the assets. U.S.-owned banks represent roughly one-fourth of all foreign-owned banks.

Due to the universal banking system in Germany, all financial institutions can engage in both banking and securities business and, thus, it is difficult to isolate the discussion to solely banking matters. Accordingly, national treatment regarding entry and treatment after entry as noted above is applicable to banking as well.

FINANCIAL MARKET DISCUSSIONS

German financial market issues have been raised in various staff and senior level discussions between the U.S. Treasury and the German Finance Ministry, the Bundesbank and the Federal Banking Supervisory Office. U.S. Government officials have complete and open access to FRG authorities and have been able to convey fully the U.S. position on matters of interest, in particular the dotation capital requirement and the cross-border data processing requirement, as well as the problem of foreign banks' participation in the government primary debt market.

CONCLUSION

Entry is not restricted and foreign institutions generally are treated comparably to local firms, although in practice, increasing market penetration is difficult to achieve. Some operational restrictions impact on U.S. firms' competitive position. The two most important concerns of U.S. financial institutions are data processing requirements and restrictions on operations of direct foreign bank branches. Branches may not participate in the federal bond underwriting consortium or lead manage foreign DM bond flotations in the FRG, although the same restrictions do not apply to subsidiaries. There are also unresolved questions concerning foreign branches' capital requirements, particularly for non-EC banks. In the federal debt market, the largest securities sector, foreign bank subsidiaries have substantially greater opportunity for the acquisition of federal bonds since the introduction of an auction technique in summer 1990. The language requirement for directors of subsidiaries also continue to concern some U.S. financial institutions in the FRG.

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*U.S. dollar figures calculated at the following rates:

1988: $1 = DM 1.7562 AA; 1.7803 YE
1989: $1 = DM 1.8800 AA; 1.6978 YE
1990: $1 = DM 1.6935 (June 1, 1990)

AA = Annual Average
YE = Year-End

Technical Appendix: Dotation Capital

In an effort to help readers better understand the issues raised for U.S. bank branches by German dotation capital requirements, this annex describes and puts in juxtaposition the operation and impact of both U.S. and German capital adequacy requirements on branches of foreign banks.

CAPITAL REQUIREMENTS FOR GERMAN BRANCHES OF U.S. BANKS

As a part of the EC internal market program for the banking sector, capital adequacy requirements (so-called endowment or "dotation" capital requirements) for German branches of banks incorporated in the EC will be abolished by the end of 1992. Capital requirements, which have been harmonized in a framework comparable to the Basle accord, will be applied to the parent bank by the home country. Direct branches of non-EC banks, however, will remain under the control of individual host countries. Therefore, German endowment capital requirements may continue in effect for German branches of non-EC banks, and some U.S. banks have complained about unfair competition. The German authorities use branch capital in setting limits on branch business, e.g., loans to one borrower. By contrast, in the United States, although branch capital requirements are imposed, branches are permitted to conduct most activities on the basis of their parents' capital.

I. EC Application of National Treatment Policy

Under a policy of national treatment, as currently applied within the European Community and in the United States, countries usually impose some type of capital requirement on the branches of foreign banks that is considered equivalent to the capital requirements imposed on domestic banks. As part of the plan to create a single banking market in the EC beginning in 1993, for services provided by EC banks across borders and through branches, the principle of national treatment is to be replaced with that of "mutual recognition" branches of EC banks will be governed by the rules and supervisory authorities of their home countries. As a result, for purposes of capital requirements, branches of EC banks will be treated like branches of domestic banks rather than as banks themselves. Consequently, as of 1993, no capital requirements will be imposed on branches of EC banks by EC host countries; the only capital limitations on the activities of these branches will be based on the parent banks' capital.

At present, the capital requirements for branches of foreign banks differ throughout the EC. The U.K. has never required branches of foreign banks to maintain their own capital. In France, while such branch capital is stipulated in principle, the measure has never been fully implemented. In Germany the authorities require branches of foreign banks to observe the same capital-based overall leverage limit as domestic banks, namely, to limit their total assets to no more than 15 times their capital, which for branches take the form of an endowment ("dotation") from the parent. Moreover, German branch capital is also used in determining the branch's limits on some of its activities, such as loans to a single customer (50 percent of capital) and open positions in foreign exchange. Dotation capital is also considered capital for tax purposes: it is subject to a 1 percent capital transfer tax (fully tax deductible) and a 1.5 percent per annum capital tax (60 percent deductible). Interest paid on dotation capital is not tax deductible.

When Germany is forced to alter this policy vis-a-vis branches of EC member banks in 1993, the result may be unequal treatment of branches of non-EC banks unless German policies are adjusted.

II. U.S. Application of National Treatment to U.S. Branches of Foreign Banks

As to capital, national treatment applied to U.S. branches of foreign banks translates into requirements similar to those imposed on branches of U.S. banks in Germany. In the United States these take the form of asset pledges and asset maintenance requirements determined by federal or, in some cases, state supervisors.

Asset pledges (APs) consist of collateral under the control of supervisory authorities, while asset maintenance requirements (AMRs) may be satisfied with "eligible" assets on the books of the branch.

For federally licensed branches of foreign banks, the Comptroller of the Currency requires a capital eqivalency deposit (CED) to be maintained in a Federal Reserve member bank in the amount of 5 percent of the branch's third party liabilities. The CED (a type of asset pledge) must be funded by the parent bank: i.e., over time, the Comptroller expects the branch to maintain a net-due-to position with its head office equal to its required CED.

State banking authorities may call for both APs and AMRs from state licensed branches of foreign banks. New York State banking law has served as a model for other states in this matter. The New York State banking superintendent requires all such branches to maintain "on deposit" high quality, marketable instruments (an AP) in the amount of 5 percent of specified third party liabilities. (This AP may be waived for insured branches subject to FDIC capital requirements; see below.) New York State licensed branches may also be called upon to "hold in the state" assets in an amount in excess of its third party liabilities (an AMR), the actual amount depending on perceived asset quality problems in the branch.

The FDIC imposes its own capital requirements, in the form of both an AP and an AMR, on insured branches, which may be in addition to those required by the Comptroller of the Currency and state banking supervisors. Only a few branches of foreign banks have chosen deposit insurance and they are all small. (As of the end of 1989, of the 362 U.S. branches of foreign banks, only 61 were insured and the combined assets of the insured branches were about 1.8 percent of the total assets of all the U.S. branches of foreign banks.)

APs and MRs imposed by bank regulators on U.S. branches of foreign banks are summarized in the tables below.

Federally Licensed
Branches

Insured	Noninsured
FDIC: AP of 5% AMR of 106%	OCC: AP of 5%
OCC: AP of 5%	

State Licensed
Branches

Insured	Noninsured
FDIC: AP of 5% MR of 106%	State: AP or MR
State: AP or MR	

In all cases, the amounts of the assets pledge or of the asset maintenance requirement are linked to the branch's liabilities, with the stated purpose of protecting U.S. creditors in the event the branch has to be liquidated.

The principal difference between the treatment of branches of foreign banks in regard to capital (or capital substitutes) in the United States and Germany concerns the use of such capital in determining lending limits or other regulatory restrictions on branch activities. In Germany, it is the branch's own capital that is the basis for capital limits, as on loans to one borrower. In the United States, almost all such limits are based on the parent bank's capital, the exception being access to the Fedwire network. In May 1990, however, the Federal Reserve Board substantially liberalized the limits governing use of the Fedwire system by U.S. branches and agencies whose supervisors adhere to the Basle capital accord. The new limits, which become effective in January 1991, are based on a fraction (10 percent) of the parent bank's worldwide capital and it is expected that this new basis will remove any grounds for complaints regarding access to the U.S. payments system.

Given the size of the foreign parent bank relative to its U.S. branch, U.S. regulations governing these branches impose virtually no formal quantitative exposure limits (in effect, asset diversification requirements) on the branch itself, and U.S. branches of foreign banks do in fact make loans considerably larger relative to their own "capital" than would be permitted a German branch of a U.S. bank.

U.S. federal and state supervisors are not indifferent to the condition of the branch as a stand-alone entity, nor to the issue of diversification and the risks posed by concentration of assets. The Comptroller of the Currency requires diversification of risk, in particular transfer risk, and expects branches with a large share of its assets due from one borrower or from borrowers in a single foreign country to reduce the position to an acceptable level. (See Federal Branch Circular-3.)

III. CONCLUSION

"Endowment" capital for direct branches of foreign banks has long been a part of Germany's regulatory framework, which aims at equalizing supervisory treatment of such branches with that of German chartered banks. As applied to branches of U.S. and other non-EC banks, these German capital requirements are expected to remain in effect.

On the basis of progressive regulatory harmonization and convergence among EC members and the replacement of national treatment by "mutual recognition" as the accepted principle for intra-EC regulation, EC banks will be regarded by German authorities as essentially domestic banks. As of January 1, 1993, endowment capital will therefore no longer be required of German branches of EC banks; at the same time, however, EC-wide banking regulations, including rules covering minimum capital, solvency ratios, concentrations of risk, will be imposed on these banking organizations as a whole.

With this change, the practical consequences of the German branch capital requirement, given the much smaller capital of a branch as compared to that of the parent bank, could restrict the business opportunities of German branches of non-EC banks, e.g., U.S. banks, relative to those of EC member banks. In this connection, it should be noted that most large U.S. banks have subsidiary banks in the EC and, provided these banks meet all the relevant EC requirements, U.S. banks may operate throughout the EC through their subsidiaries on the same basis as EC banks.

U.S. regulatory authorities impose capital (or capital substitute) requirements on U.S. branches of foreign banks that are in may ways analogous to those required of German branches of U.S. banks. In contrast with German practice, U.S. federal and state supervisors do not look to the branch's own capital (or capital substitutes) as a basis for determining exposure to one borrower or any other quantitative limits on the branch's business. Formal quantitative limits on activities of U.S. branches of foreign banks are based on the foreign bank's capital.

U.S. supervisors address the need to ensure the safety and soundness of foreign banks' U.S. branches by means of more flexible approaches than the capital-based restrictions used in Germany. Generally these methods consist of forms of moral suasion, supplemented where necessary with specific legal sanctions directed at problem situations.

While "mutual recognition" would not be feasible as a principle for governing U.S.-EC relations in banking (it could require, for example, U.S. authorities to allow U.S. branches of EC banks to engage in nonfinancial activities), there are strong reasons for German authorities to consider treating branches of non-EC banks in a manner substantially equivalent to the way branches of EC banks are treated.

First of all, there is the issue of fair competition for non-EC banks, especially for those from countries that have similar and equally effective bank supervision standards as EC countries, such as the United States, Japan, Switzerland, and Canada. Secondly, some banks believe that the prospective opening up of internal banking markets has stimulated increased interest in some EC countries, including Germany, in becoming the center for European banking. If the German authorities are interested in getting multinational banks from outside the EC to consider making Frankfurt, say, their European headquarters, they may adjust their regulations vis-a-vis direct branches of non-EC banks. As noted above, the U.K. does not impose capital requirements on branches of non-EC banks and the French requirements are, in practice, minimal.

Table 1

FRG Capital Market Overview

	(DM Billion)		
(1) Primary market	1987	1988	1989
Total issues of bonds and shares	129.6	124.1	159.3
of which:			
Bonds	113.0	89.8	118.9
domestic bonds	88.2	35.1	78.4
--bank bonds	28.4	-11.0	52.4
--industrial bonds	0.0	0.1	0.3
--public bonds	59.8	46.2	25.6
foreign bonds	24.8	54.7	40.5
Shares	16.6	34.3	40.4
domestic	11.9	7.5	19.4
foreign	4.7	26.8	21.0
(2) Secondary market			
Total trading in bonds and shares	2,034.5	2,557.2	3,292.7
of which:			
Bonds	1,185.8	1,840.9	1,916.2

--bank bonds	16.4	26.7	16.0
--public bonds	1,075.5	1,647.8	1,737.2
--foreign DM-bonds	72.8	121.4	101.9
Shares	848.8	716.4	1,376.6
--domestic	671.2	615.2	1,181.8
--foreign	57.8	38.8	60.2
--warrants	119.9	62.4	134.5

(3) Other characteristics of the FRG stock exchanges

	(year-end 1989)		
	Total	Domestic	Foreign
Number of securities Listed	16,887	15,148	1,739
-- shares	1,350	749	601
-- bonds	15,219	14,170	1,049
-- warrants	318	229	89
Number of Corporations Listed	1,163	628	535
-- (pct.of total corporations in the FRG)	- -	(25.2)	- -

	1987	1988	1989
Total capital listed of domestic corporations (DM Bill.)			
-- nominal value of shares	58.4	59.3	63.8
-- market value of shares	345.5	446.6	620.0

Structure of share ownership
(year-end data; pct. of total)

Sector	1970	1980	1988
private households	28	19	20
business	41	45	40
public authorities	11	10	6
nonresidents	9	11	13
banks	7	9	9
insurance companies	4	6	12

Sources: Annual Report 1989, Federation of the German Stock Exchange; Dresdner Bank

Table 2

FRG Federal Government Debt Instruments

Instrument	German name	Method of issue	Maturity
Federal bonds	Bundesanleihen	syndicate, dutch auction for recent FRNS	8-12 yrs., normally 10 yrs.
Federal savings bonds	Bundesschatzbrief	tap	type a: 6 yrs.; type b: 7 yrs
5-year special notes	Bundesobligationen	tap	5 yrs.
Medium-term notes	Bundesschatzanweisung/1	dutch auction, some private placement	3-6 yrs.
Treasury discount paper	U-schaetze	auction and open market sales, some private placement	6 mo.-2 yrs.
Treasury financing paper	Finanzierungsschaetze	tap	1 or 2 yrs.
Treasury bills	Bundesschatzwechsel	open market sales	30-90 days, sometimes a few days
Negotiable loan agreements	Schuldscheine	private placement	1-15 yrs.

Table 2 (continued)

FRG Federal Government Debt Instruments

Instrument	New issues	Outstanding debt/2 Pct. DM Bill.	 Pct. of total
Federal bonds	23.7	195.8	39.9
Federal savings bonds	-1.5	33.4	6.8
5-year special notes	4.2	93.9	19.1
Medium-Term notes	-0.8	43.4	8.8
Treasury discount paper	0.2	4.0	0.8
Treasury financing paper	6.4	7.8	1.6
Treasury bills	-	/3	-
Negotiable loan agreements	-14.1	92.1	18.8
Misc. /4	-2.7	20.1	4.1
Total	15.4 /5	490.5	100.0

1/ Formerly known as Kassenobligationen or Federal Treasury Paper.
2/ Year-End 1989
3/ Outstanding debt not applicable due to short-term nature.
4/ Mostly direct lending by nonbanks and old debt.
5/ Net basis, change in outstanding debt after redemptions and expiring debt.

Table 3

Assets of German Banking Groups
(Year-end 1989; DM Billion)

Type of Bank	Total Assets	Pct. of Total	Claims on Nonbanks
I. Commercial banks	3,287.1	78.1	2,107.1
1. Private Commercial Banks	1,032.0	24.5	670.6
-- "Large" Banks /2	395.9	9.4	266.6
-- Regional Banks and other commercial banks /3	495.1	11.8	341.4
of which: subs of foreign banks	111.4	2.6	56.0
-- Branches of Foreign Banks	78.6	1.9	23.8
-- Private Banks	62.5	1.5	38.7
2. Public Banks	1,561.6	37.1	946.5
-- Savings Banks	904.3	21.5	591.1
-- Central Giro Institutes	657.3	15.6	355.4
3. Credit Cooperatives	693.5	16.5	490.0
-- Cooperative Banks	514.1	12.2	323.6
-- Central Cooperative Banks	179.4	4.3	54.5
II. Specialist banks	922.7	21.9	612.7
1. Mortgage Banks	576.5	13.7	435.5
2. Other /4	346.2	8.2	177.2
Total	4,209.9	100.0	2,608.0

Table 3 (continued)

Assets of German Banking Groups
(year-end 1989; DM billion)

Type of Bank	Number of Institutions	Number of branch offices /4
I. Commercial banks	4,142	39,685
1. Private Commercial Banks	321	6,286
-- "Large" Banks /2	6	3,110
-- Regional Banks and other commercial banks /3	169	2,821
of which: subs of foreign banks	68	433
-- Branches of Foreign Banks	60	34
-- Private Banks	86	321
2. Public Banks	594	17,578
-- Savings Banks	583	17,359
-- Central Giro Institutes	11	219
3. Credit Cooperatives	3,227	15,821
-- Cooperative Banks	3,223	15,789
-- Central Cooperative Banks	4	32
II. Specialist banks	155	176
1. Mortgage Banks	37	38
2. Other /4	118	138 /5
Total	4,297	39,861

Memo item /6:

	Total assets	Pct. of total	Pct. of foreign banks /7	Number /8
	(DM Bill., year-end 1988)			
I.Total foreign banks	168.1	4.3	-	162
-- subs	18.0	3.0	-	102
-- branches	50.1	1.3	-	60
II.Total U.S. banks	48.7	1.2	29.0	33
-- subs	40.6	1.0	34.4	22
-- branches	8.1	0.2	16.2	11

1/ Source: Deutsche Bundesbank, Monthly Report

2/ Deutsche, Dresdner, Commerzbank and their legally independent subsidiaries in Berlin (West)

3/ Including German subsidiaries of foreign banks.

4/ Banks with special functions, and others.

5/ Excludes approximately 18,000 postal bank offices and subpost offices.

6/ Source: "Foreign Banks in the FRG 1990," Association of Foreign Banks.

7/ Percent of each category.

8/ For foreign banks, end 1989, same source as 1.

38. Italy - Securities

SUMMARY

The Italian securities market can be broken into two major parts. The first and by far the largest is the government securities market. The second is the private securities market which includes various types of equity instruments and a limited amount of fixed rate obligations. The government securities market is dominated by banking institutions which act as underwriters and brokers as well as dealers in a secondary market. The Government has focused on the development of this market because of its desire to place as much as possible of the large and rapidly increasing stock of public debt in private hands.

By contrast, the market for nongovernment securities has remained small and is relatively undeveloped. This market is likely to experience a major transformation over the next several years once a series of bills become law and are implemented. The most significant bill would create a new financial intermediary that could perform a wide range of financial services including brokerage, underwriting, individual portfolio management and financial advice. A major objective of the reform would be to concentrate securities transactions, which now occur outside the exchange, with banks playing a major role. Other bills under consideration would control insider trading and public tender offers. Upon enactment of a law approved in September 1990, an antitrust authority will be established.

Italy's financial markets are open. U.S. financial firms generally receive national treatment. The one notable exception, the role of stockbrokers, which is limited to Italian citizens, is likely to end after passage of proposed legislation. (The key issue, however, has not been the restrictions on individuals, but those barring firms, both foreign and Italian, from being stockbrokers.) Foreign banks are active in the securities market in Italy, but account for a small share of the market.

As noted above, national treatment is generally provided.

OVERVIEW

Domestic Securities Markets

Types of Instruments: Italy's securities market is dominated by the public sector. The Government issues a wide range of securities ranging from three-month bills to long-term variable rate certificates. These securities are denominated in lire and ECUs. The Treasury also issues bonds denominated in various foreign currencies. They account for less than three percent of the stock of public debt and are traded outside Italy. As a general policy, the Treasury has attempted to lengthen the average maturity of its debt.

Medium-term and long-term securities account for about 50 percent of total Treasury debt, whereas instruments with a maturity of one year or less account for about 25 percent. The balance of the debt is held by the postal savings system and the Central Bank. Most Treasury securities are bearer instruments and can be easily negotiated. Since 1986, interest on Treasury securities has been subject to a withholding tax, now 12.5 percent. Interest income of individuals is not subject to further taxation.

Many of the non-Treasury bonds issued are done in the name of public sector enterprises. Bonds are either fixed-rate or convertible into shares. The latter were popular in the mid-1980s when share prices were increasing. In recent years, issues of convertible bonds as well as ordinary bonds have declined.

Another phenomenon of the mid-80s was the so-called savings shares, or preferred shares, which carry no voting rights. In 1986, savings shares accounted for forty percent of total capital raised by quoted companies, a figure that dropped to one percent in 1988. Mutual funds developed rapidly in the 1980s, as a vehicle for small and medium-sized investors. Their growth peaked in 1987. Subsequently their net assets declined until June 1990, but have since steadied at around $40 billion.

Volume of Transactions: Government securities accounted for 79 percent of net security issues in 1989. Share (i.e., stock) issues accounted for 14 percent, with the balance accounted for by bonds issued by public credit institutions and state-owned companies. Redemption of private bonds exceeded new issues. By comparison, in 1980, shares accounted for 13 percent of new security issues, while Treasury securities accounted for 73 percent.

The Treasury has accounted for much of the increase in total securities since 1980, but shares continue to make up a significant portion of the private sector's financial assets -- 31 percent at end-1989 versus 23 percent at end-1980. The increase in the holding of shares resulted from a sharp rise in prices of Italian shares from 1980 to 1986, and a more than tenfold increase in holdings of foreign shares. Holdings of Treasury securities accounted for seven percent of private financial assets in 1980, and 41 percent in 1988. The portion accounted for by claims on financial institutions declined from 45 to 24 percent over this period.

The volume of share transactions on Italy's ten stock exchanges increased dramatically in the early 1980s from an average daily turnover of 25 billion lire ($16.5 million)* in 1983 to 283 billion lire ($189.8 million) in 1986, when prices peaked, then slipped to 231 billion lire ($177.5 million) in 1988. It is estimated that only one quarter to one-third of transactions in listed companies' shares take place within the exchanges. Trading is concentrated in the shares of less than ten major groups. Gross issues of Treasury securities in 1989 amounted to 591 trillion lire ($430 billion), or 96 percent of gross security issues. The value of Treasury securities that changed hands through the Bank of Italy clearing system was almost half the amount issued.

Location of Markets: There are ten stock exchanges in Italy, located in Milan, Rome, Genoa, Turin, Bologna, Florence, Naples, Palermo, Trieste and Venice. Milan's transactions account for over 90 percent, with Rome and Turin in distant second and third places. The exchanges are independent of each other although plans exist to link them by telematic screens, thereby creating a de facto national market. The system of continuous trading is in the process of being introduced. As noted previously, trading on the exchanges accounts for only a small portion of trading in shares and an even smaller portion of trading in government securities. There is an active, informal telephone market. An official wire market in Treasury issues rapidly developed, after it started in 1988. Using Reuters screens, a number of Treasury securities are quoted with dealers (mostly banks) making a market in the listed securities.

Market Participants: Trading on the floor of exchanges is limited to stockbrokers who must be Italian citizens and act in a personal capacity. The stockbrokers have a monopoly on transactions executed on the floor of the exchanges. Commission agents (which can be owned by banks) and banks have desks just off the trading floor for relaying orders. These institutions also buy and sell securities over the counter without going through stockbrokers. Commercial banks have windows in many of their branches to take orders for securities transactions. The banks serve as the main intermediary for smaller savers and handle much of the "backroom" business for stockbrokers. Banks have also organized mutual fund management companies with large distribution systems. In addition, banks engage in individual securities portfolio management and the assets in such accounts are larger than those in similar accounts managed by other securities intermediaries, including trust companies, licensed by the Ministry of Industry.

Regulatory Officials: The Commissione Nazionale per le Societa e la Borsa or National Commission for Corporations and the Stock Exchange, known by the acronym CONSOB, is the principal regulatory agency for stock exchanges. The Bank of Italy regulates banks' securities activities and exercises control over the issue and placement of securities in the domestic financial market. The Ministry of Industry regulates the trust or portfolio management companies. Proposed legislation will modify the responsibilities of regulatory agencies.

Changes since 1986: The actual operations of Italian securities markets are little changed from 1986. Notable changes include the effective operation of Montetitoli, a security depository. Its operation has accelerated the settlement process. The secondary market for Treasury securities has been improved by the introduction of a telematic screen with dealers. Improvements in electronics have made national trading feasible.

Several bills now being discussed in Parliament will make major changes in the organization and functioning of Italy's securities markets. These bills may be approved by end-1990, or sooner. The description below is based on the bills as now drafted.

The most important legislation is the "Discipline of Security Intermediation." The bill provides for a security intermediation company, known by the Italian acronym of SIM. The SIMs will be corporations with shares and must be registered with CONSOB. The minimum capital of a SIM is 600 million lire ($481,000) -- three times that for a corporation (currently 200 million lire). Additional risk-weighted capital requirements can be established by the Bank of Italy, upon agreement with CONSOB. SIMs will be empowered to: (a) negotiate securities for their own account or for third partners, that is, act as a broker and a dealer (b) underwrite and distribute securities (c) manage individual portfolios (d) solicit orders for security transactions (e) provide financial advice and (f) solicit public savings.

SIMs will also be empowered to operate in all exchanges, thus gradually eliminating the monopoly of stockbrokers. CONSOB will regulate and supervise the operations of SIMs, whereas the Bank of Italy will supervise capital adequacy and set capital ratios. The two agencies will jointly establish various operating regulations. In order to concentrate transactions on exchanges and maximize transparency, all transactions by SIMs must be on an exchange; exceptions are permitted at the client's request, provided the best price will be achieved as a result. CONSOB and the market, as well as the client, must be notified of such transactions. Banks will be required to follow the same rules and may have to establish SIMs for this purpose.

The Treasury security market is excluded from these provisions. The trust companies (societa fiduciarie) now licensed by the Ministry of Industry will have to convert themselves into SIMs within a set time. During a transition period of up to 18 months, SIMs must have a stockbroker as a shareholder. This is a quid pro quo in getting the stockbrokers to surrender their monopoly. The transition provision remains particularly controversial and its final form is up in the air. The SIM bill also gives CONSOB the authority to establish a single, national exchange and the operating rules thereof. CONSOB is also empowered to establish rules for trading various types of financial instruments linked to securities, interest rates and foreign exchange.

Another important proposed law will regulate insider trading. The bill prohibits the use of insider information to purchase or sell stocks on Italian or EC member country exchanges, or the communication of such information to third parties for such stock transactions. CONSOB is to implement a regime for electronic registration of stock transactions, and will investigate suspected infractions. Penalties for violation of the provisions are imprisonment for up to one year, and a fine of from one million to 100 million lire ($800-$80,000) or up to three times the profit realized in the involved transaction. The bill also contains provisions to allow CONSOB to share information with other countries. Legislation to establish norms for public tender offers is also being discussed.

As of May 1990, all significant restrictions on investment abroad by Italian residents were lifted as part of the movement toward a unified European market. This liberalization has made Italy, because of its high personal savings rate, an important investor base for foreign financial institutions to tap.

U.S. Presence in the Market

U.S. commercial banks and stockbrokers have been established in Italy for decades. U.S. commercial banks generally receive national treatment but foreign stockbrokers do not; they are limited to giving advice since Italian stock exchanges bar firms, both foreign and Italian, and permit only Italian individuals to be stockbrokers. The role of commercial banks has changed considerably in recent years. After an increase in the number of branches of U.S. commercial banks in Italy to a peak of 14 in 1984, the U.S. presence has declined. At end-1988, there were 38 branches of foreign banks in Italy with 62 outlets. Bank of America sold its long-established and large subsidiary Banca D'America et Italia to Deutsche Bank in 1988. Several other U.S. banks have sold branches, reducing or ending their physical presence in Italy. Most of the remaining banks have redirected their activity, de-emphasizing financial intermediation in favor of fee-based income activities. One major U.S. bank has acquired an Italian bank with a network of branches.

Several U.S.-based investment banks have established offices in Italy. These appear directed at giving advice and soliciting business for other markets rather than undertaking operations in Italy's securities market. U.S.-based institutions located outside Italy are increasingly interested in Italian securities and in tapping Italian savings. In addition to the traditional role these institutions have played in underwriting and otherwise arranging external borrowings for Italian entities, they are now investing in Italian securities and soliciting Italian savings for foreign investments.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

The foreign share of the Italian financial market has been small relative to that of other major European countries. Comparable, aggregated data for foreign-owned financial institutions is not published by regulatory agencies, but rough estimates indicate that branches of foreign banks account for roughly 2 percent of total bank assets and 2 percent of total loans. Deposits fund less than one-tenth of the loan portfolio. Subsidiaries of foreign banks would roughly double these numbers. In certain types of instruments, the share of foreign banks is significantly higher. Reasons for the limited role of foreign banks include the small size of the nongovernment securities market, a limited interbank money market, bureaucratic obstacles to establishing a retail banking network (which would also market securities) and the existence of exchange controls, which hindered foreign portfolio investment outflows and deterred inflows. These conditions are changing, and so is the interest of foreign financial entities.

Entry into the Italian securities market is usually done through the establishment of a branch bank. Branches of foreign banks can operate directly in both the primary and secondary (telematic) government securities market, trading securities for their own account or that of customers. Foreign bank branches are also permitted to take orders for shares which can be executed directly or through dealers (commissionarie di borsa) or stockbrokers. Banks are licensed by the Bank of Italy, which determines that the applicant is reputable. There is a minimum capital requirement, recently halved to 12.5 billion lire ($10 million). The Bank of Italy maintains an open door to foreign banks, based on reciprocity regarding the right of establishment. The Bank of Italy has also approved, indeed even encouraged, the purchase of shares in existing Italian credit institutions. The Central Bank recognizes the role that foreign financial institutions can play in the development of Italy's financial sector. Once established, foreign bank branches enjoy national treatment.

Establishing an entity to provide financial services other than solicitation of public savings and various market activities that require banking sources is reasonably easy. Italy does not now have a law covering the establishment of investment or merchant banks. Entities providing many of these services can be set up as an ordinary corporation.

As noted above, the SIM bill, if passed, will dramatically change the Italian securities market. The text, as it now stands, provides broad authority to the regulatory agencies to establish operating rules. There is nothing in the text of the bill that would provide a basis for discrimination against foreign financial entities. Statements by Italian officials confirm that they will welcome foreign participation in the SIMs.

A number of questions arise regarding the implementation of the law. Notably, what will be the position of existing firms during and after the transition period? Will any company offering financial advice have to incorporate as a

SIM? This would mean that the one-person or two-person firm would need a substantial capital investment compared to the practice in the U.S. How will the SIMs legislation relate to the EC directive on financial services? The SIMs will be subject to much greater control and closer regulation than is the case now; indeed, one reason for the legislation is to eliminate what some Italians call the "wild west" or lack of regulation that now exists. The insider trading and public tender offers bills and the antitrust law are also part of this effort. It is hoped that greater control will be exercised in a way that will not stifle but rather promote innovation and economic efficiencies.

Domestic Banking Market

Italy permits the establishment of bank branches on the basis of reciprocity with national treatment afforded thereafter. As noted above, foreign banks are active in Italy. The number of foreign bank branches is increasing, though the number of U.S. bank branches has declined. The reasons for the declining U.S. presence include poor profit records and corporate decisions to redirect priorities. The role of foreign banks in total banking intermediation is very small, roughly one percent, as discussed earlier.

With the advent of 1992 and the Second Banking Directive, Italian banks are looking for alliances with other EC banks. This takes the form of outright purchases and cross shareholdings. These deals are going in both directions, with cross shareholding being more common than the opening of branches in Italy. Many large and small Italian banks are not established as corporations, but rather as special legal entities subject to public control. A law approved in July 1990 permits the banks to incorporate and thereby open the way to further mergers with both Italian and foreign banking institutions. According to the Bank of Italy the recently approved antitrust law sets rules governing equity interests in banks with a view to two distinct ends: 1) it establishes controls in an area where their current absence permits any person, Italian or foreign, to acquire an equity interest in a bank without approval by the credit authorities; 2) it regulates ownership relationships between banks and firms in nonfinancial sectors in light of the principle of separation. In particular, the law introduces a 15 percent ceiling on the equity interests in banks of nonfinancial and nonbank companies. The law assigns to the Bank of

Italy the responsibility for applying the law's prohibitions on: agreements that restrain freedom of competition (and any derogations in this respect); abuse of a dominant market position; and mergers that restrict competition.

CONCLUSION

National treatment is generally provided and some minor improvements have been made. Although the GOI has adopted a more relaxed policy toward bank entry rules, reciprocity at establishment still applies. All foreign banks, which in Italy can engage in securities activities, can open branches throughout Italy and lending is no longer geographically limited. While capital requirements have eased for non-EC banks (lire 12.5 billion vs. previously lire 25 billion needed to establish a branch), EC banks will be relieved of this constraint consistent with the EC Second Banking Directive. Although neither foreign nor domestic corporations may operate as stockbrokers, this restriction disproportionately impacts on foreign firms. Pending legislation is expected to redress this.

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*U.S. dollar figures calculated at the following rates:

1983: $1 = lire 1,518.8 AA
1986: $1 = lire 1,490.8 AA
1988: $1 = lire 1,301.6 AA
1989: $1 = lire 1,372.1 AA
1990: $1 = lire 1,247.25 (June 1, 1990)

AA = Annual Average

39. Netherlands - Securities

SUMMARY

The Netherlands has a universal banking system, but various financial institutions engage in the securities business. Banks in the Netherlands are licensed to engage in essentially all forms of securities-related activities. The primary securities market is dominated by commercial banks, but brokers and other institutions compete with the banks in offering securities trading and investment services. Most of the operations associated with new issues are performed by commercial banks, which also hold large securities portfolios.

Traditionally, Dutch financial and securities market participants have enjoyed a large degree of freedom, and for years foreign capital and securities transactions have been free of restrictions. Foreign financial institutions have ample opportunities to participate in the Netherlands securities markets. Under the Netherlands Securities Transactions Act of 1986, stock exchange members in all EC countries may engage in securities brokerage activities in the Netherlands for all securities listed on their respective stock exchanges. Foreign persons or firms that are not a member of the Amsterdam Stock Exchange or other EC stock exchanges may also engage in securities-related activities in the Netherlands under a license granted by the Ministry of Finance.

Relatively few U.S. securities firms are active in the Dutch market. Subsidiaries of U.S. firms established in the Netherlands are primarily involved in over-the-counter (OTC) trading in U.S. securities for Dutch institutional investors. They have not encountered formal or informal barriers in the Dutch securities market.

National treatment is generally available to firms established in the Netherlands.

OVERVIEW

Domestic Securities Markets

The Primary Market

In 1989, borrowing on Dutch capital markets amounted to 62 billion guilders ($29.2 billion)* or more than 14 percent of national income. This demand was met primarily by institutional investors (pension funds and life insurance companies) and commercial banks. In 1989, these two categories each furnished an average 43 percent of total capital raised. Since the early eighties, the share of capital furnished by foreign investors grew to 24 percent, while the share of private sources (households and industry) dropped to below one percent.

The public sector accounted for roughly 37 percent of total borrowing, leaving 48 percent, or 30 billion guilders ($14.1 billion) to the private sector. Foreign borrowing rose from five percent in the early eighties to 12 percent in the mid-1990, primarily due to the liberalization of Dutch capital markets.

The Secondary Market

The Stock Market: The Dutch stock market is dominated by the securities of a few large multinationals (Royal Dutch Shell, Unilever, AKZO, Philips). Trading in multinational stock accounted for approximately 39 percent of total turnover by the Amsterdam Stock Exchange (ASE) in 1989. In addition to the multinationals, other important issuers are commercial banks, insurance companies, trade and industrial companies and shipping and aviation concerns. At the end of 1989, the ten largest companies listed on the ASE accounted for 59 percent of total market capitalization. Royal Dutch Shell stock alone covered approximately 27 percent of market capitalization.

In 1980, the Amsterdam Stock Exchange began trading foreign shares under the Amsterdam Security Account System (ASAS). Under the ASAS system, no physical handling of share certificates is involved, and all settlements and transfers are done by book-entry. The major advantage of the system is the absence of costs associated with bearer certificates. It allows the use of home-market settlement practices.

Today ASAS includes securities of companies with headquarters in Australia, Bermuda, Canada, Denmark, France, Hong Kong, Japan, Norway and the United Kingdom. In 1989, more than 100 securities were traded under the ASAS. Since 1984, the ASAS has also included Eurobonds which comply with AIBD rules. In 1989, approximately 120 Eurobonds were listed.

Capital market liberalization and the need for a more efficient secondary market, particularly for large, predominantly institutional investors led to the establishment of the Amsterdam Interprofessional Market System (AIM) in 1986. The AIM was designed specifically to allow trading at reduced costs by a larger number of investment firms to improve the competitive position of trading in the Netherlands.

The AIM system provides for direct negotiation and allows commercial banks and brokers to trade in blocks of listed stocks or bonds without charging the obligatory commission. Transaction minimum limits are 2.5 million guilders ($1.3 million) for bonds and one million guilders ($524,000) for equities. Transactions concluded through the AIM bypass the intermediary function of the specialist on the stock exchange floor but must be reported to the stock exchange AIM desk within 15 minutes so that the information can be incorporated into the price quoted on the floor. The number of transactions through the Amsterdam Interprofessional Market System rose rapidly to over 11,500 in 1989, with a turnover of 40 billion guilders ($18.9 billion) in bonds and 13.3 billion guilders ($6.3 billion) in shares. Total listings on the official market amount to over 1,900 securities, of which 65 percent are guilder and foreign currency-denominated bonds and 35 percent shares, warrants and rights. The ASE lists an estimated 300 foreign securities, the majority of which are of American companies. Roughly 60 percent of foreign securities are traded in home market currencies through the advanced Amsterdam Securities Account System (ASAS).

The number of new stock and bond issues has risen rapidly in recent years. 1989 was a banner year for the Amsterdam Stock Exchange with the volume of new securities issues growing to 67.2 billion guilders ($31.7 billion) including a record 20.1 billion guilders ($9.5 billion) of new shares issued (more than twice the 1988 level). On the bond market the volume of new issues in 1989 fell slightly to 41.5 billion guilders ($19.6 billion).

Mutual fund shares may be offered to the public either under license granted by the Ministry of Finance (MOF) or without a license if the shares are listed on a stock exchange (covered under the Securities Act), or managed either by a financial institution (under the supervision of the Netherlands Bank) or by a member of the stock exchange.

The Bond Market: At the end of 1989, the Dutch bond market amounted to 1,249 bonds outstanding valued at 269.4 billion guilders ($140.6 billion). Annual turnover in the bond market in 1989 fell by 16 percent to 173.2 billion guilders ($81.7 billion). Bonds are traded on the Amsterdam Stock Exchange and the Amsterdam Interprofessional Market. Trading on a net basis is permitted. Approximately 700 million guilders ($367 million) worth of bonds are traded daily. More than 80 percent of annual bond trading, 144.4 billion guilders ($68.1 billion), is in government bond issues. This is only a fraction of total trade in Dutch Treasury issues. An estimated 60 percent is traded via the London stock exchange directly between banks, brokers and investors.

Total (foreign and domestic) borrowing on the bond market amounted to 46.1 billion guilders ($21.7 billion) in 1989. The largest issuer in the Dutch bond market is the Finance Ministry's agent in Amsterdam, which finances the bulk of the budget deficit with guilder-denominated bonds. In 1989, the Dutch Treasury accounted for 70.9 percent of new bond issues. Foreign borrowing fell to 5.0 percent of total borrowing in 1989.

The Dutch bond market also facilitates the issuing of foreign bonds and bonds floated by quasi-government agencies and local governments, mortgage banks, and trade and industry. The main foreign institutions which use the Dutch bond market to raise capital are the World Bank and various foreign governments. Bonds floated by foreign governments are equivalent to Yankee bonds in the U.S. and Samurai bonds in Japan.

Foreign investors and Dutch institutional investors are the largest categories of investors in Treasury issues, accounting for 34 percent and 26 percent, respectively. Pension funds and commercial banks are the largest investors in nongovernment securities. As a result of financial market deregulation and the introduction of bullet bonds, the number of foreign investors in guilder-denominated bonds has been increasing since 1986.

Futures and Options Markets

The European Options Exchange: To allow the independent trading of share options, the European Options Exchange (EOE) was established in 1978. Carefully modeled on the Chicago Board Options Exchange (CBOE), the EOE grew to be the largest options exchange outside the United States.

EOE contracts are standardized according to size, strike price and duration, and are tradable and exercisable at any time (American style) or at expiration date (European style). Trading on the options exchange consists of approximately 32 classes of short- and long-term options covering about 25 stocks listed on the Amsterdam Stock Exchange, eleven Dutch government bonds, two currencies and gold. Equity options cover 100 shares on the underlying stock and are priced in Dutch guilders. Included is the Major Market Index (MMI) option, a broad-based group of twenty top-quality American shares which are listed on the New York Stock Exchange and some of which are listed on the Amsterdam Stock Exchange.

The EOE is open to Dutch and foreign banks and brokers, and EOE membership requirements are less stringent than those of the Amsterdam Stock Exchange. To participate in public order business, floor broking, market making or clearing, the ownership of at least one of the EOE's present 384 seats is required.

Since its establishment, the number of trade contracts has grown to over 13 million. In 1989, roughly 74.6 percent of EOE trading was in stock options, with the remaining 25.4 percent in stock index options (14.9 percent), bond options (3.6 percent), bond index options (1.5 percent), currency options (3.6 percent) and precious metals (1.8 percent).

The EOE options program was expanded in early 1990, when the EOE introduced an option on the index of the five largest internationally traded shares (Royal Dutch/Shell, Unilever, AKZO, Philips and KLM) listed on the ASE. The EOE has launched a new European stock index, E100. The E100 includes 100 separate European listed funds. In March 1990, EOE seats traded close to 700,000 guilders ($367,000) per seat.

The Amsterdam Financial Futures Market (FTA): To meet the demand for new products, the European Options Exchange established the Amsterdam Financial Futures Exchange in 1987. The FTA is a wholly owned subsidiary of the European Options Exchange. Clearing is provided by the European Future Clearing Corporation, which is largely owned by the European Options Exchange. Financial futures trading in Amsterdam includes futures based on a bond index, a share index and a bond future similar to the Bund future traded on the London International Financial Futures Exchange.

The FTA has so far sold over 200 of its 250 seats to commercial banks and brokers to act as clearing members, intermediary brokers or market makers. In 1989, the FTA traded over 376,000 futures contracts. The program was recently expanded with a future based on the index of five major international shares listed on the Amsterdam Stock Exchange.

Types of Securities Exchanges

The Amsterdam Stock Exchange: The Amsterdam Stock Exchange, established at the beginning of the 17th century, is the oldest stock market in the world. The Dutch East India Company was the first company in the world to be financed by an issue of stock shares to the public. Since 1989, the Ministry of Finance has mandated its oversight authority over the official securities market to the Securities Board of the Netherlands (STE). The Ministry of Finance retains direct oversight responsibility over the unofficial securities market.

Compared with the dynamic growth of other European stock exchanges, the expansion of the Amsterdam exchange has been relatively modest. The exchange association has been criticized for being too cautious, for example, in its automation plans. One of the major factors for capital market deregulation was keeping Amsterdam competitive as an international finance center.

At the end of 1989, total market capitalization in equities in the Amsterdam Stock Exchange was about 299 billion guilders (about $156.1 billion). Annual sales rose from 93 billion guilders ($34.5 billion) in 1982 to 365 billion ($190.6 billion) in 1989, while the average amount per transaction grew from 41,000 guilders ($16,400) in 1981 to over 157,000 guilders ($82,000) in 1989.

The Size of the Amsterdam Stock Exchange
($ billions, unless noted)

	1988	1989
Number of companies with equity shares listed on the ASE	517	544
(of which foreign companies)	(231)	(231)
Market value of equity shares of domestic companies	108.5	156.0
Market value of bonds and debentures	130.4	140.7
Effective trading in equity shares	62.1	90.5
Effective trading in bonds	104.7	81.6
Pre-tax dividend yield on exchange listed stocks (percent)	4.3	4.0

In early 1990, the Amsterdam Stock Exchange counted 160 member firms with activities divided among banks, brokers and specialists. Members of the ASE can be legal entities operating in the Netherlands which, as their main business or major part of their activities, act as intermediaries in the securities business (agent) and/or deal in securities for their own account (principal).

According to the nature of their business, members of the ASE can be divided into three major categories:

a. Commercial banks and broker-banks (credit institutions registered with the Netherlands Central Bank NB).

b. Brokers (firms not registered as credit institutions with the NB).

c. Hoekman firms (exchange market makers comparable to specialists at the New York Stock Exchange).

Commercial banks act as intermediaries between the exchange and the public and represent their clients in the execution of orders. Hoekman firms work for independent firms and act as intermediaries between commercial banks and brokers. The Hoekman firms have no legal or financial relation with either banks or brokers. Hoekman firms receive a commission for their services.

Membership of the ASE is open to foreign banks and brokers when established according to the legislation of one of the Member States of the European Community. At least one of the partners or managing directors must reside in the Netherlands. Thus, a non-EC institution would have to have some established presence in Amsterdam. A foreign firm, broker or foreign bank is allowed to set up a subsidiary or an office to collect stock exchange orders within the country and/or abroad.

Banks and brokers may be trading or nontrading members of the ASE. Nontrading members trade through a trading member firm. Professional experience on the stock exchange floor is required to deal on the ASE.

Ownership of more than 25 percent of the equity of ASE member banks or brokers by nonmembers is subject to the approval of the Amsterdam Stock Exchange committee of delegates. In addition, ownership of more than 10 percent by floor specialists (Hoekman) is also subject to approval. Commercial banks and stockbrokers are not allowed to take an interest in specialists; specialists are not allowed to take an interest in either commercial banks or brokers. An exception is made when the shares of a commercial bank or broker are listed on the ASE and held by the Hoekman as a trading position rather than as part of an investment position.

New listings on the Amsterdam Stock Exchange can be obtained through introduction by trading if the security is listed on a stock exchange of another EC member nation or of an authorized non-EC country (such as the U.S.). In addition, an issue can be listed provided it meets minimum requirements regarding the publication of a prospectus and the size of the issue. When securities are introduced by trading, the selling party offers a number of existing shares for sale through the members of the exchange.

Mutual fund shares may be offered to the public either under a license granted by the Ministry of Finance or without a license if the shares are listed on a stock exchange (covered under the Dutch Securities Transaction Act of 1986), or managed either by a financial institution (under supervision of the Central Bank) or by a member of the stock exchange.

Until July 1, 1990, the ASE maintained a system of fixed commission rates and a stamp duty was levied. To improve the competitive position of the Dutch securities market, both the system of fixed commissions and the stamp duty were abolished. As of July 16, 1990, the ASE introduced an "open order book" for the most actively traded bonds to facilitate bond trading by large professional investors. Since early 1990, the Amsterdam Stock Exchange has been a system of fixed settlement for securities transactions. In line with Eurobond market practices, the system calls for a seven-day securities transactions settlement.

The Amsterdam Parallel Market: The Amsterdam parallel market was established in 1982 to provide financial opportunities for companies not yet listed on the official market and to provide the shareholders of parallel market listed companies with increased liquidity. The Amsterdam parallel market is governed by regulations of the ASE and operates under supervision of the Securities Board of the Netherlands. The parallel market is regarded as a first step toward full listing on the official market.

The ASE plans to introduce an official parallel market index and a separate listing of the most active parallel market issues toward the end of 1990. The ASE will raise the capital threshold for the official market. Finally, the ASE is seeking to establish a clear differentiation between the official market, the official parallel market and the unofficial, unregulated, over-the-counter trade of unlisted stock.

The parallel market is run by intermediaries or specialists. The services of specialists are required in executing orders in parallel or over-the-counter stock. The client cannot demand the immediate execution of an order. Since its establishment in 1982, the number of companies listed on the parallel market has grown to over 73 issues with a total market value of roughly 5 billion guilders ($2.6 billion).

Securities Market Regulatory Authority: The securities operations carried out by commercial banks are supervised by the ASE within the rules of prudential banking supervision. Since 1989, all members of the Amsterdam Stock Exchange and the options and futures exchanges have been subject to supervision by the Securities Board of the Netherlands (STE). The STE, in turn, operates on behalf of the Ministry of Finance. The Ministry of Finance has oversight over OTC activities.

STE supervises the official stock, options and futures markets. The STE is a private foundation operating at arms length from the Government. It is not authorized to start criminal investigations. It may only act as a supervisor. The STE must ensure that the exchanges have adequate means of investigating securities market problems.

Legislation before Parliament in mid-1990 is seeking to expand STE authority to include the over-the-counter securities market, which is now under the supervisory responsibility of the Ministry of Finance. Under this legislation, the STE will no longer operate on behalf of the Ministry of Finance but will have its own authorities. The STE will be given wider authorities in relation to firms operating on the exchanges and on the over-the-counter securities market. The STE will also be able to take measures against members who violate regulations of their respective exchanges if the exchanges fail to take action. The STE will have the authority to investigate applicants for membership and warn investors of unauthorized dealers. In addition, the STE will be able to initiate investigations in alleged insider trading cases. The STE also acts as MOF's advisor on securities legislation particularly with regard to EC directives.

Progress Since 1986: Dutch regulations covering the securities markets were significantly eased during 1986. New capital market regulations relaxed requirements for guilder-denominated bonds, commercial paper, floating rate notes and discount bonds. The most important liberalization for the bond market was the introduction of short-term bullet bonds which made guilder-denominated bonds more compatible with German government bonds. The increase in liquidity caused a substantial rise in foreign interest in the Dutch bond market. In 1988, medium-term notes were introduced in the Dutch Market.

The Amsterdam Exchange adopted a model code to prevent insider trading and put the code into effect on January 1, 1987. The Stock Exchange Association's Stock-Watch Department has monitored price movements and trading to spot cases which might signal insider trading. An insider trading act which became effective in 1988 has been criticized for imposing penalties that are too mild. Such offenses are punishable by up to two years imprisonment and fines of 100,000 guilders ($52,440) for individuals and one million guilders ($524,400) for corporations. Illicit profits derived from insider trading transactions can be confiscated.

The Insider Trading Act of 1989 also has consequences for U.S. violators, because the Netherlands and the U.S. signed an executive agreement on the exchange of securities trading information in 1989 in order to combat fraud and irregularities. The securities agreement, the first signed by authorities on a government-to-government level, will facilitate the exchange of information through the STE. The agreement is also the basis for further cooperation on a wide range of issues affecting the U.S. and Dutch securities markets.

At the end of 1989, the ASE introduced new regulations, imposing some restrictions on takeover defenses, which had previously been allowed for companies listed on the ASE. Companies seeking a listing for the first time will have to abide by the new rules. The new takeover rules also apply to previously listed companies which plan to introduce changes in their defenses by changing the company's articles of association. Companies with articles which already allow the takeover defenses will be effectively grandfathered. For example, a major Dutch electronics company created a third layer of takeover defenses by doubling its share capital and by issuing preferred stock to friendly parties.

In March 1990, the Ministry of Finance (MOF) introduced draft legislation regulating the compulsory disclosure of shareholdings in Dutch companies. The bill provides for disclosure of interests at thresholds of 10 percent, 25 percent, 50 percent and 66.6 percent, where shareholders increase or decrease their stakes to cross these thresholds. Reporting to MOF and the company involved and public disclosure by the company itself in all EC Member States will be required without delay. Responsibility for supervision of the Disclosure Act will be delegated to the STE, and failure to meet disclosure requirements will be a criminal offense. MOF's draft law responds to a 1988 EC directive which is aimed at making the EC securities market more transparent.

U.S. Presence in the Market

American banks and securities firms participate in the Dutch securities market through a relatively small number of subsidiaries. U.S. firms established in the Netherlands are primarily involved in OTC trading in U.S. securities purchased by Dutch institutional investors. Subsidiaries of U.S. securities firms are active participants of the Amsterdam Stock Exchange, the European Options Exchange and the Amsterdam Financial Futures Market. U.S. financial institutions established in the Netherlands to conduct securities business generally receive national treatment and meet no formal or informal barriers in their activities in the Dutch securities market.

U.S. securities firms, banks or brokers listed as members of the Amsterdam Stock Exchange are:

- Prudential-Bache securities (Holland) NV.
- Citicorp investment bank (the Netherlands) NV, a 100 percent subsidiary of Citibank Overseas Investment Corp. Wilmington, Delaware.
- Credit Suisse First Boston Nederland NV, 100 percent subsidiary of Financiere Credit Suisse-First Boston, ZUG, (Switzerland).

U.S. firms listed as public order members (or public order correspondent members) of the European Options Exchange are:

- Credit Suisse First Boston Nederland NV
- INC Trading Corporation
- Merrill Lynch International & Co. C.V.
- Morgan Nederland NV (J.P.)
- Prudential-Bache Securities (Holland) NV
- Paine Webber International Futures LTD

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks and securities firms may enter the Netherlands to undertake securities business by establishing branches or subsidiaries, or by acquiring existing Dutch institutions. Foreign banks may engage in securities-related activities under the same regulations that apply to Dutch banks subject to a reciprocity requirement. Foreign securities companies may participate in the securities market with or without a banking license. Banks need a banking license in order to operate in securities activities. A license is granted by the Netherlands Central Bank (NB) if the bank has: a minimum amount of its own funds and an experienced fit and proper management of at least two persons. They may perform all relevant activities as long as no deposits are accepted. Foreign financial institutions established in the Netherlands to conduct securities business generally receive national treatment.

Under the Netherlands Securities Transactions Act of July 1, 1986, stock exchange members and credit institutions in all EC countries may engage in securities brokerage activities in the Netherlands for all securities listed on their stock exchange without a special license.

Foreign persons or firms that are not members of the Amsterdam or other EC Stock Exchange may also engage in securities-related activities in the Netherlands under a license granted by the Finance Ministry. Licensing conditions include experience, expertise, financial guarantees and information reporting requirements.

Foreign corporations or persons may become members of the Amsterdam Stock Exchange and engage in securities-related business on the exchange. Membership requirements include establishment in the Netherlands either through a subsidiary, a branch or a representative office. In the latter two cases, the foreign corporation can become a member provided it is a corporation established in an EC member-state. Thus, as a condition for membership, foreign firms are required to incorporate in the Netherlands or any other EC member country. A number of foreign corporations and brokers, including the Dutch subsidiaries of U.S. banks, are members of the Amsterdam Stock Exchange.

Foreign firms with branches or subsidiaries in the Netherlands may engage in securities-related activities under the same regulations that apply to Dutch banks, subject to a reciprocity requirement that prohibits foreign banks from acting as lead manager of guilder-denominated bond issues in the Netherlands unless Dutch banks are afforded comparable treatment in the parent country of the foreign bank in question.

The role for foreign financial institutions in marketing government debt (or other public sector securities) of the Netherlands is dependent, to a large extent, on their membership on the Amsterdam Stock Exchange. Securities issued by the Government of the Netherlands are marketed by the agent of the Ministry of Finance which offers the securities for auction to members of the Amsterdam Stock Exchange. Thus, there is no syndication of such issues. Other public authorities and institutions in the Netherlands do not issue securities, but finance capital improvements through private placements or issues floated by the Bank Van Nederlandse Gemeenten (Bank for Dutch Municipalities), or the Nederlandse Waterschap Bank (Bank of Dutch Waterboards) on the Amsterdam Stock Exchange. The offerings of the Bank for Dutch Municipalities are marketed by a group of members of the Amsterdam Stock Exchange, while the offerings of the Bank for Dutch Waterboards are underwritten by a syndicate of Dutch banks. Over the years, the Bank for Dutch Municipalities has become a large issuer of medium-term notes. The two banks are quasi-public with shares owned both by local authorities and the Dutch State.

Domestic Banking Market

U.S. banks in the Netherlands are subject to the same laws and regulations as domestic banks. In general, U.S. banks in the Netherlands receive national treatment. Dutch banking regulations do not impose any direct or indirect barriers to U.S. banks.

CONCLUSION

National treatment is generally available to firms established in the Netherlands. Dutch financial markets are generally open to foreign firms. Securities regulations were eased significantly in 1986. Lead managing guilder-denominated bond issues, however, is subject to a reciprocity requirement, which does not appear to be a barrier for U.S. banks. Firms not incorporated in the Netherlands or another EC country face separate licensing requirements for securities-related activities and have limitations on their underwriting activities.

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*U.S. dollar figures calculated at the following rates:

1981: $1 = guilders 2.4952 AA
1982: $1 = guilders 2.6702 AA
1989: $1 = guilders 2.1207 AA; 1.9155 YE
1990: $1 = guilders 1.9071 (June 1, 1990)

AA = Annual Average
YE = Year-End

40. Switzerland - Securities

SUMMARY

U.S. financial firms are well-established in Switzerland and participate in a broad range of securities activities. Many bank-like finance companies (nondeposit taking), which had not previously been subject to the Swiss Federal Banking Law's reciprocity and capital adequacy provisions, will be required to conform by the end of 1992. While not welcomed by affected U.S. institutions, the change is not expected to have major consequences for U.S. institutions as a group. There is no federal securities market legislation. The cantonal (state) laws which currently govern the individual securities exchanges contain some elements of discrimination against foreigners, although in the case of the Zurich exchange these were recently removed.

The only remaining capital control is the requirement that lead managers and underwriters of Swiss Franc-denominated bonds and notes of foreign issuers be domiciled in Switzerland. A side-effect of this has been the formation of a permanent syndicate for public bond issuance which holds a dominant market position. However, it appears that changes in the structure of the capital market have reduced the syndicate's relative importance. In addition, the Government recently ordered the syndicate to eliminate one of its most restrictive practices. The basically open and unregulated nature of the Swiss financial center has allowed important markets to develop rapidly in new instruments, such as equity-related and derivative products. As part of global financial institutions, U.S. firms have been in a good position to benefit from these dynamic changes.

De jure national treatment is provided.

OVERVIEW

Domestic Securities Markets

Supervision: Switzerland has a universal banking system which allows banks to undertake the full range of securities activities. Banks are subject to the supervision of the Federal Banking Commission. There is no comprehensive federal securities legislation. The individual stock exchanges are subject to cantonal regulation. Recently, a consensus has emerged that federal legislation is needed to introduce, inter alia, regulations consistent with EC/OECD norms and eliminate differential treatment between foreign and domestic securities market participants. The Federal Department of Finance has appointed a group of experts to draft a federal securities exchange law by the end of 1990. Enactment of federal securities legislation, however, will probably take several years.

Under federal banking legislation, the basic distinction between banks and bank-like finance companies is that the latter do not solicit deposits from the public. Many finance companies are involved in underwriting bond and note issues or offering derivative financial instruments on the primary market.

Prior to January 1, 1990, bank-like finance companies were not subject to Federal Banking Commission supervision and were required to comply with just two of the banking law's provisions. One required the submission of an annual balance sheet to the Swiss National Bank and the other required adherence to the National Bank's capital export regulations. These finance companies were not subject to a reciprocity requirement regarding establishment, or to the same capital adequacy requirements as banks.

On January 1, 1990, finance companies which obtain a substantial volume of interbank financing or lead or co-manage new issues became subject to all provisions of the banking law and must conform to it by the end of 1992. The intent is to improve the supervisory authorities' ability to ensure the proper functioning of the market, promote competitive equality and remove a loophole regarding reciprocity. The Banking Commission has said that it will be flexible in implementation, especially regarding reciprocity. The change contains no "grandfathering" provision.

Capital Export Regulations: Effective October 1988, a general authorization was granted for Swiss franc credits (individual loans as well as lead management of and participation in syndicated credits) and for currency swaps negotiated with a partner domiciled abroad. However, lead managers and underwriters of foreign securities, either denominated in Swiss francs or linked to the franc, continued to be restricted to institutions domiciled in Switzerland.

Money Market: For a variety of reasons, the Swiss domestic money market is not well developed. There is little public debt. In addition, a federal securities (stamp) tax makes issuance of short-term paper prohibitively expensive. The Federal Government's primary short-term instrument is the money market debt register claim (MMDRC) which is exempt from the stamp tax. Recently, in an effort to improve the secondary market in MMDRCs, the National Bank authorized one of the largest Swiss banks to act as a market maker. The outstanding volume of MMDRCs is estimated to be only about SFR 1 billion ($696.4 million).*

Domestic Bond Market: Domestic bonds and notes are issued by public authorities, finance institutions, insurance companies and other public or private domestic companies. In 1989, total new issues were SFR 15 billion ($9.2 billion), of which SFR 14.2 billion ($8.7 billion) were bonds (public placements). At the end of 1988, the debt of the federal, cantonal (state) and local governments amounted to about SFR 83.3 billion ($53.9 billion), of which less than one-third was federal debt; the stock of repayable federal debt amounted to about SFR 24.7 billion ($16 billion).

Issues of nongovernment entities, the most important category in the domestic market, are typically underwritten by syndicates of domestic banks headed by one of the big Swiss banks. Foreign investors have shown little interest in these issues, as the interest payment is subject to a 35 percent withholding tax. According to private sector statistics, Switzerland's big three banks lead manage a little over half of domestic issues and cantonal banks about 25 percent.

The most important federal government issues are long-term bonds and medium-term notes. At the end of 1988, about 60 percent of outstanding federal debt was medium and long-term. Long-term bonds have been sold by public tender since 1980. A convention establishing a fixed underwriting syndicate to distribute the issues, which has been inoperative since establishment of the tender system, formally expired at the end of 1989. Medium-term notes are private placements sold directly by the Federal Finance Department to selected banks. This procedure maximizes flexibility and allows the Government to raise funds relatively inexpensively and quickly.

Foreign Bonds and Private Placements: In 1989, total issues of foreign bonds and private placements were valued at SFR 31.7 billion ($19.4 billion), down substantially from the previous year. Equity-related issues accounted for about 70 percent of the total. The share of private placements, which normally runs about 50 percent, rose to over 70 percent. Japanese borrowers accounted for almost half of total foreign issues. The largest share of these were equity-related.

Bonds: Public issues are lead managed and underwritten by syndicates of banks and bank-like finance companies domiciled in Switzerland. The most important is the syndicate of the big banks, led by Switzerland's three largest banks. Another permanent syndicate, of much less importance, is headed by the subsidiaries of foreign banks. Issues not underwritten by either permanent syndicate are managed by ad hoc syndicates, which contain predominantly foreign institutions.

Under terms of the big banks' syndicate's rules, only the big three have the right to lead manage issues. Others must receive approval from the big three before accepting a mandate. Also, members cannot participate in an underwriting consortium led by a nonsyndicate member (loyalty clause). The Federal Cartel Commission has recommended that these rules be abolished. This was rejected by the syndicates. In early September 1990, the Federal Government ordered the syndicate to abolish the loyalty clause by the end of 1990. Subsequently, the big three banks announced that their syndicate would be formally abolished by year-end. While a welcome move, it is unclear exactly what impact this will have on competitive conditions. Reportedly, members of the big banks' syndicate already participate in nonsyndicate underwriting as "silent partners."

The grey market for foreign bonds is one in which bonds are traded between the initial syndication date and when the bonds are listed on a stock exchange. The market was first developed in late 1985 by U.S. banks operating in Geneva (grey market trading is banned in Zurich). Subsequently, the major Swiss banks have joined. According to U.S. firms, the grey market has diminished the advantage of belonging to the big banks's syndicate, since that market permits nonmembers to participate in the placement of the syndicate's bonds.

Private Placements (Notes): These include both straight debt and equity-related issues. Private placements do not need to be listed on an exchange, do not require a published prospectus and are not advertised. These factors, along with a minimum denomination of SFR 50,000 ($34,800) make private placements a relatively cheap and flexible means to raise funds. Purchasers are typically institutional investors.

Covered Warrants: In 1989, a market in Swiss franc-denominated covered warrants rapidly expanded. The majority of new foreign issuers were Japanese. The market was estimated at SFR 4.7 billion ($2.9 billion) in 1989, up from under SFR 1 billion ($683.4 million) in 1988, according to one major bank. Trading in covered warrants is not subject to the federal stamp tax and an active secondary market exists.

Soffex: The Swiss options and financial futures exchange began operation in May 1988. It is fully computerized, and exchange members throughout Switzerland place their orders and quotes directly on their computer terminal. Soffex has been established as a limited liability corporation with its shares held by the Tripartite Association of Exchanges (Zurich, Basel and Geneva) and the major Swiss banks. Members of the Swiss stock exchanges and other professional securities dealers with offices in Switzerland can be members of Soffex. Options contracts exist on 13 of Switzerland’s leading corporations and on one stock index. Futures trading is expected to begin by the end of 1990. Mandatory trading on the exchange and designated market makers in specific securities are innovations which Soffex has brought to the Swiss market.

Stock Exchanges: In practice, members of the major stock exchanges are banks. Several foreign banks are members, especially, of the Zurich exchange. Finance companies are represented in the over-the-counter (OTC) market.

The securities laws of the cantons of Zurich and Basel have designated "A" licenses, which allow trading on the exchange, and "B" licenses for the OTC market. Both the firm and its individual representative must hold a license. Firms can be Swiss-based subsidiaries or branches of foreign enterprises located in the canton, but individuals, until recently had to be Swiss citizens, cantonal residents and have five years trading experience. In the spring of 1990, Zurich eliminated the Swiss citizenship requirements.

The stock exchanges are planning to convert to a fully computerized system (similar to Soffex). The first phase, trading in straight bonds, is scheduled to start in 1991.

Securities Admissions Board: In order to be listed on the exchanges, both foreign bonds and shares must be approved by the Swiss Admissions Board. The admissions board is a private organization, though its membership includes nominees of the Federal Finance Department. Decisions on admission are based primarily upon quality criteria (creditworthiness). In recent years, this procedure has been defended because of the emergence of "junk bonds." However, the board is viewed as being dominated by the big banks, and its ability to make objective decisions has been questioned. If true, the board's decisions could discriminate against the listing of issues to be lead managed and underwritten by foreign banks and finance companies. The board is considering various means to alter its admissions procedures, one of which would establish a separate market segment for trading lower grade bonds. A Finance Department report recommended that the same admissions procedures be applied to both foreign and domestic borrowers. This would call for admission based upon improved publication rules for both domestic and foreign borrowers (e.g. more detailed prospectus and balance sheet statements in conformance with international norms). The report also refers to the desirability of independent credit rating organizations established on a volunteer basis. A future federal securities law might mandate changes.

The Federal Cartel Commission, in its report on the cartel agreements in the banking industry, applicable to the country as a whole (of April 1989), noted that the Swiss Admissions Board considerably inhibits competitiveness in the primary market. After the publication of the report the Swiss National Bank addressed a declaration to all co-signatories of the "Convention concerning the admission of foreign securities for official trading on the Swiss stock exchanges" terminating its partnership to the agreement. The other signatories to the Convention have agreed to continue operating the Admissions Board in its present form for a limited period, though without the central bank's right to obligation laid down in the Convention.

Brokerage: A brokerage convention has long existed under the auspices of the Stock Exchange Association (banks). The convention sets uniform percentage fees by type and size of transaction. The Cartel Commission has recommended that the convention be phased out over time and a

Government decision on the recommendation has been pending. While rejecting the Cartel Commission's recommendation, the Association of Stock Exchanges did modify the convention at the beginning of 1990 in order to introduce more flexibility in the setting of fees. In September 1990, the Federal Government ruled that the convention be abolished by the end of 1992.

Only banks can belong to the Swiss Securities Clearing Office (SEGA). However, since July 1989, brokers and finance companies have been allowed to adhere to SEGA through its subsidiary Intersettle.

U.S. Presence in the Market

U.S. financial institutions are well-represented in the Swiss market. Entry is accomplished through branching, establishment of subsidiaries and acquisitions of existing institutions. At present, seven U.S. banks have branches in the country and about eight own bank subsidiaries (a few have both branches and subsidiaries). U.S. securities houses also own Swiss banks. There are about 10 U.S.-controlled finance companies. Several of these have the same parent as a bank branch or subsidiary. Securities activities are usually conducted by a finance company, though some bank subsidiaries engage in such activities as well. The extension, as of January 1, 1990, of all provisions of the banking law to many finance companies is expected to result in a reduction in their number, while the number of banks will increase. There are approximately 15 U.S. brokerage houses in Switzerland (some of which also operate banks or finance companies, as well as brokerage operations narrowly defined). Most brokers have offices in more than one city.

U.S. financial institutions are active in the lead managing and underwriting of Swiss franc foreign bonds and notes. In 1989, U.S. firms led about a quarter of the approximately 26 percent of issues not led by one of the major Swiss banks. This occurred despite the virtual absence of U.S. borrowers.

Geneva-based subsidiaries of U.S. financial institutions remain active in the grey market. As noted elsewhere, the existence of this market improves the competitive opportunity of firms which are not members of a strong syndicate.

In 1989, U.S. financial institutions were major players in the Swiss franc-denominated covered warrants market. U.S. firms held five of the top ten book-runner positions in 1989 for the entire covered warrants market, of which the biggest sector was in Swiss francs.

U.S. presence in the domestic market, on the other hand, is not significant. However, in 1989, a U.S. bank was invited to participate in the bidding for the initial distribution of a federal medium-term note (private placement). This was the first time that the Finance Department solicited foreign banks and a U.S. firm successfully bid. In addition, a U.S. bank lead managed an equity-related issue of a medium-sized Swiss bank.

A number of foreign financial institutions are members of the Zurich Stock Exchange. However, in March 1990, the one U.S. member announced its withdrawal due to financial considerations.

According to the Federal Finance Department, there are 250 foreign and 340 domestic shares listed on the Swiss stock exchanges. Swiss secondary markets (excluding that for covered warrants) are not known for their liquidity. This is especially true for fixed-income issues which investors often hold until maturity.

With no U.S. institution on the Zurich exchange, U.S. brokerage is limited to the over-the-counter market. U.S. brokers are also active in selling U.S. shares listed on U.S. exchanges directly to residents of Switzerland.

TREATMENT OF U.S. FOREIGN FINANCIAL INSTITUTIONS

The Federal Banking Law, its implementing ordinance, and the ordinance on foreign banks all contain language on reciprocity. The legislation defines reciprocity to mean that Swiss resident persons are permitted to open banks in the foreign country and that the business operations of these banks are not subject to materially more limiting provisions than those imposed on foreign banks operating in Switzerland. With respect to the U.S., reciprocity is determined on a state-by-state basis. The states of California, Colorado, Connecticut, Florida, Illinois, Indiana, Massachusetts, New York, Ohio, Pennsylvania, Texas and Wisconsin are deemed to accord Swiss banks such treatment. In other cases, the situation is undefined.

While in theory, the reciprocity provisions could result in barriers to establishment for U.S. banks, there is no indication that, in practice, this has been the case. Apparently, a state would fulfill the reciprocity conditions as long as a Swiss bank could be established in it as a federally chartered bank.

Federal banking legislation also requires that a banking license applicant be subject to "adequate supervision" in its country of origin. This can affect U.S. securities firms applying for a Swiss banking license. But the practical consequences do not appear to have been great since several securities houses operate bank subsidiaries in Switzerland.

The amendment to the banking law's implementing ordinance could affect U.S. finance companies in a number of ways. Along with the reciprocity and adequate supervision requirements, these include increased administrative and capital costs.

It is probably fair to say that none of the U.S. finance companies welcomes the change. The lack of a "grandfathering" provision is compared unfavorably with the treatment which Swiss banks received under the 1978 International Banking Act. In addition, the move to introduce reciprocity is widely interpreted as being directed at the numerous Japanese finance companies which have been established in recent years.

The adequate supervision criteria potentially could affect those finance companies which have not already established Swiss bank subsidiaries. However, recently the finance company subsidiary of a securities house had its banking license application approved on the basis of understandings reached with the Federal Banking Commission and the SEC.

Apparently, those institutions with both bank and finance company subsidiaries could fold the latter's operations into the former. (Glass-Steagall prescriptions preclude the possibility of branches taking on these operations.) However, some securities houses, with no desire to support the cost of meeting banking license requirements, could face a difficult decision regarding continued operation.

In 1988, the Swiss subsidiaries of three West German banks were invited to join the big banks' syndicate. These were the first (and to date only) foreign banks allowed to do so. Reportedly, "reciprocity" was a factor in the big banks' decision, and one which would preclude U.S. banks or finance companies. At the time, some fears arose that the syndicate's expansion would result in a greater concentration of market power. However, recent results do not indicate that this has been the case. As noted previously, the Government recently ordered the syndicate to abolish its loyalty clause, although this measure may be meaningless if the syndicate is formally abolished. An eventual elimination of the domicile requirement would result in even more fundamental changes, although this seems unlikely prior to modification of the stamp tax.

A number of years ago, informal agreements existed between some Swiss banks and foreign brokers, according to which, brokers desiring to do business with Swiss banks must use them as intermediaries for purchases or sales of foreign securities for Swiss residents. If such agreements still exist, there is no indication that they impede foreign brokerage activity.

Under Swiss law, foreign and domestic investment trusts offered to the public in Switzerland or from Switzerland are required to have a custodian bank. Those without a custodian bank, for example some brokers, can sell funds to their clients, but not advertise.

Transfers of bonds, shares and other participation rights, and investment fund units are subject to a stamp tax of 0.15 percent for domestic instruments and Eurobonds and 0.30 percent for Swiss franc foreign instruments (excluding covered warrants). While this tax applies equally to domestic and foreign firms, it impedes the trading of foreign issues and effectively precludes the marketing of short-term instruments. However, the federal 35 percent withholding tax does not apply to foreign issues. Various proposals to reform the stamp tax have been made and a committee of Parliament is giving the issue priority treatment.

Virtually all U.S. bankers (and other businessmen) complain that Switzerland's tight restrictions on granting work permits to nonresident foreigners both raise operating costs and inhibit their ability to expand operations. However, domestic banks and firms are subject to the same rules. The issue is a sensitive one in Switzerland since foreigners already account for over 20 percent of the work force.

Domestic Banking Market

In addition to their securities activities, U.S. bank subsidiaries and branches are involved in a broad range of banking activities. International private banking has long been a primary reason for the establishment of foreign bank operations. In 1988, foreign banks accounted for over 50 percent of fiduciary (trust accounts) transactions.

Other activities of U.S. banks in Switzerland include foreign exchange and precious metals trading, trade finance, customer lending and some teller activities. However, retail banking activities are limited, apparently out of choice.

At the federal level, equal competitive opportunity appears to be provided in all areas with the exception of real estate related financing. Swiss law strictly limits foreign acquisition of property (with the exception of premises directly related to business activities). While this is not directed at foreign banks, it apparently limits their ability to participate in real estate secured lending. This could include lending to any domestic firms with large real estate holdings.

CONCLUSION

De jure national treatment is provided. Foreign firms are not generally constrained from doing securities business in the Swiss financial markets but some irritants have been cited. Despite the existence of some troublesome regulatory requirements, U.S. financial institutions have considerable operational opportunities in Switzerland which have been pursued vigorously. The opening of the "big banks" underwriting syndicate to foreign participation is a welcome move, even though U.S. firms are not involved. Restrictions on work permits for foreigners handicap all securities firms in Switzerland as does the tax on securities transactions.

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*U.S. dollar figures calculated at the following rates:

1988: $1 = SFR 1.4633 AA; SFR 1.5465 YE
1989: $1 = SFR 1.6359 AA
1990: $1 = SFR 1.436 (June 1,1990)

AA = Annual Average
YE = Year-End

41. United Kingdom - Securities

SUMMARY

Of the major financial centers in the world, the United Kingdom is perhaps the most international. Well developed, highly sophisticated markets exist in London across the full spectrum of money and capital markets as well as in foreign exchange, futures, options, insurance and commodities. International business is large relative to domestic business.

Foreign and domestic securities firms are treated in substantially the same way in the United Kingdom. Foreign financial institutions can readily enter business in the U.K. by branching, establishing a subsidiary, or acquiring an existing institution.

Since the 1986 Update, both the regulatory regime and the organization of the securities markets in the U.K. have undergone major transformations. Implementation of the Financial Services Act of 1986 has introduced a far more formalized and codified system of financial regulation. Reforms of stock exchange membership rules and trading practices in the "Big Bang" of 1986 have substantially changed the way the U.K. securities markets are organized. With these changes, most of the minor exceptions from national treatment that were noted in the 1986 Update have been eliminated.

Foreign firms are now permitted to become International Stock Exchange members. They may also lead manage sterling issues. Further, the stamp duty on share transactions, as well as on the purchase of American depository receipts, will be abolished late in 1991.

There are two potential exceptions to the national treatment of foreign securities firms in the U.K. First, the Financial Services Act includes a reserve reciprocity provision. It has never been used, but nevertheless exists on the books. The legislation gives the authorities power to either restrict entry of new firms or to curtail activities of established firms on the basis of reciprocity considerations. As implemented, the Act does not appear to have discriminated against U.S. financial institutions.

Second, the Governor of the Bank of England has stated that the takeover of a major U.K. bank by a foreign entity would not be viewed favorably by the Bank of England. That view may be tested, if the rumored merger discussions between Midland Bank and Hongkong and Shanghai Banking Corporation come to fruition.

In general, foreign firms enjoy full national treatment and expanded business opportunities.

OVERVIEW

Domestic Securities Markets

In 1989, the Bank of England reported that in banking, London held a 19 percent share of global cross-border banking assets, larger than any other world center. In February 1990, 259 institutions incorporated outside the United Kingdom were authorized to take deposits in the U.K. There are also a large number of both UK-incorporated institutions with foreign parentage and representative offices of overseas institutions in the U.K. The total number of foreign bank offices was 548. The Eurobond market is centered in London with almost all such issues structured in London and 65 percent of all primary issuances taking place in London. Three quarters of secondary market trading in Eurobonds takes place in London. It is estimated that between 5 and 10 percent of the turnover in U.S. government bonds takes place in London. In German government bonds, the turnover in London is estimated to reach 30 percent of total trading. More foreign companies are listed on the stock exchange in London than in any other market, and one half of the turnover on the International Stock Exchange is in these international shares. Daily turnover in the foreign exchange market in London is larger than in Tokyo or New York. Futures and options business is growing rapidly, and in 1989, London accounted for 7.5 percent of daily global turnover in these markets.

The last Update of the National Treatment Study was completed at the time of substantial financial deregulation in London's markets. The centerpiece of the new regulatory structure is the Financial Services Act of 1986 (FSA). It outlines regulations for securities and investment activity in the U.K., making it unlawful to carry on investment business without authorization or exemption. (For example, wholesale money market activities may be exempted if companies are listed by the Bank of England as qualifying market-makers or brokers. The banks' supervisory/ eligibility criteria are otherwise similar to those of SROs, including observance of all codes of conduct which reflect market practice overseas.) The Department of Trade and Industry (DTI) has statutory authority for implementation of the FSA. Detailed regulatory authority has been delegated to the Securities and Investments Board (SIB). Day-to-day regulation is further delegated to a group of self-regulatory organizations (SROs). Banks that carry on investment business are regulated by the Bank of England in respect to banking business and by the SIB or an SRO in relation to investment business.

In most cases, authorization is obtained through membership in an SRO. The SRO responsible for the securities industry is The Securities Association (TSA). Other SROs are defined along functional lines. Authorization can also be obtained directly from the SIB. Applicants must have sufficient capital, demonstrate adequate controls, and be considered "fit and proper." The latter test is administered by the Bank of England, the SIB and the SROs. The Bank of England has to be satisfied that a person is "fit and proper" to become a director, controller or manager of an authorized institution. Where the Bank wishes to take action in relation to a controller, it must show that, on a balance of probabilities, the controller is not "fit and proper" to hold the position. Where it considers this requirement is not met, the Bank is required to give reasons for its decisions. In both cases, there is an appeal to an independently constituted Banking Appeals Tribunal and then on a point of law to the courts. Applicants refused authorization by the SIB have the right to appeal to the Financial Services Tribunal established by Section 96 to 101 of the Financial Services Act of 1986. The SIB is obliged to provide a full explanation of the reasons for refusing an application and the Tribunal can carry out its own independent investigations. To date, no problems have arisen in this area.

The SROs are required to promulgate and impose on their members rules regarding conduct of business and financial resources that meet the standards prescribed by the SIB as mandated by the Financial Services Act. The SROs have the authority to discipline their members and to revoke the membership of firms where circumstances warrant such action. The SIB will only intervene if the SRO fails to take action or when the SRO refers the matter to the SIB.

The U.K.'s multi-tiered regulatory regime also includes Recognized Investment Exchanges (RIEs). Like SROs, these domestic securities exchanges or markets must receive recognition from the SIB and are responsible for supervision, compliance and the maintenance of orderly markets. SROs and RIEs can delegate to each other responsibility for monitoring, but not enforcing, compliance, thus giving the exchange some indirect regulatory responsibility. The largest exchange in London is the International Stock Exchange. It is responsible for the functions outlined above and is playing an integral role in preparing London for the competitive challenges presented by the Single European Market. In addition to playing the major role in automation, clearance and settlements, the ISE has announced that it will be working closely with the exchange in Frankfurt to develop a unified system for Europe. Unlike domestic investment exchanges, overseas investment exchanges must be recognized by the DTI.

U.S. Presence in the Market

The 1986 Big Bang in the stock exchange and the restructuring that accompanied it, along with the changes introduced with implementation of the Financial Services Act of 1986, opened major new opportunities for foreign firms. Corporate membership was allowed on the stock exchange opening, permitting entry of foreign securities firms and encouraging increased capitalization. Mergers and buy outs of well-established but weakly capitalized British firms were common, creating entry opportunities for both domestic banks and foreign groups. U.S. firms participated actively in this process. By 1989, out of a total International Stock Exchange corporate membership of 415 firms, 155 were owned by non-U.K. residents and 49 of these were American-owned. American firms are also well represented on the executive committees of the International Stock Exchange.

The membership of TSA shows a similar international flavor. A little more than half of TSA's membership of 945 firms consists of non-U.K. owned firms, 150 of which are American. American firms participate actively in TSA; the chairman of TSA is an American.

The market in U.K. gilt-edged securities and the sterling money markets have also been reorganized and internationalized in recent years. Foreign firms, including American houses, have become authorized market makers in the gilts markets, functioning in a capacity similar to primary dealers in the U.S. Treasury market. Foreign firms are also prominent in the wholesale money markets, including foreign exchange, bullion and interest rate derivatives.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign firms are treated equivalently to domestic firms under the regulatory regime outlined in the FSA. U.S. firms can enter the securities business in the U.K. by branching, forming subsidiaries or acquiring domestic firms. Entry in all these forms was quite active in the run-up to "Big Bang" in 1986. Approximately 10 percent of all TSA members and 15 percent of all Stock Exchange members are either branches or subsidiaries of U.S. parents. Although several large U.S. institutions have closed their operations in the past two years, these actions were not in response to the U.K. regulatory environment but due to over-capacity in London's markets.

To facilitate the entry of foreign firms, U.K. authorities have gone to considerable lengths to mitigate the problems of conflicting home and host country regulations. U.K. authorities have entered into Memoranda of Understanding (MOUs) with several foreign regulators, including the United States. These MOUs cover such things as exchange of information, capital adequacy and supervision. In addition, The Companies Act of 1989 improved arrangements for international cooperation among regulators by increasing the scope for regulators to rely on each other in authorizing, monitoring and supervising financial institutions.

While U.S. takeovers have been a successful means of entry into the securities business, there is some doubt if U.K. authorities would allow a foreign-based institution to take over one of the largest U.K. clearing banks. Bank of England Governor Robin Leigh-Pemberton stated in a speech at the President's Banquet of the Northern Ireland Chamber of Commerce, 13 October 1987: "As a general rule, we would not wish to stand in the way of overseas participation in a British bank or financial institution. But it runs counter to common sense to argue that the openness of the London market must be carried to the point where control of the core of our financial system may pass into the hands of institutions whose business aims and national interests lie elsewhere." That policy may be tested if rumored merger discussions between Midland Bank (third largest U.K. clearing bank in terms of shareholders' funds and balance sheet assets) and Hongkong and Shanghai Bank Corporation continue.

Under the Fair Trading Act of 1973, the Secretary of State for Trade and Industry may block a proposed merger or acquisition if it is determined not to be in the "public interest." Only qualifying mergers, currently those which would result in combined assets of over 30 million pounds ($50.5 million)* or a market share of at least 25 percent, are examined by the Office of Fair Trading and may be referred to the Monopolies and Mergers Commission for a "public interest" determination.

The Fair Trading Act requires that the commission consider all relevant factors when making its determination. The current Government's primary consideration has been the effect on competition. "Foreign ownership might affect the public interest -- for example, in relation to a sector of strategic importance or in cases where the nationality of the owner might affect export prospects. Such points would need to be considered."

The Banking Act of 1987 empowers the Bank of England to control -- on prudential grounds - changes of ownership of authorized institutions incorporated in the UK. No person may become a minority, majority or principal shareholder or indirect controller (as defined in the Act) of such an institution unless he has notified the Bank, and either the Bank has notified him that there is no obligation, or a period of three months has elapsed since the original notification to the Bank. A person who becomes a significant controller (as defined in the Act) of an authorized institution incorporated in the UK is required to notify the Bank of England.

U.K. law with respect to foreign financial firms permits application of the principle of reciprocity; it does not mandate national treatment. The FSA contains a reciprocity provision conferring sweeping reserve powers on British officials in cases where U.K. persons are deemed not to receive reciprocal treatment in their conduct of investment, insurance and banking business in other countries. These reserve powers have never been formally invoked but they do represent a tacit threat to countries with firms seeking market opportunities. The existence of the reciprocity provisions undoubtedly provided leverage to

U.K. authorities in their negotiations with the Japanese on entry for U.K. firms on the Tokyo Stock Exchange. Although no formal linkage was officially acknowledged, applications by two Japanese securities firms to be gilt-edged market makers were deferred until it was evident U.K. firms would be allowed access to the Tokyo Stock Exchange.

The Financial Services Act provides for potentially sweeping sanctions in cases where reciprocity is denied. Specifically, should U.K. firms not enjoy "terms as favorable" as those extended in the U.K. to firms from the country in question, U.K. officials may serve notice upon firms of such countries restricting the type of business those firms may undertake in the U.K. for either a specified or an indefinite period. Further, U.K. authorities can prohibit them from conducting all investment, insurance or banking business in the U.K. The Act requires the authorities to consult "so far as they consider expedient" with firms likely to be affected before service of such notice.

The Act allows the authorities to revoke later any restrictive notice if it appears to them that the conditions that gave rise to it no longer pertain. Revocation is not tantamount to authorization as that would have to be pursued with the appropriate authorities.

Once established in the U.K., foreign financial institutions receive national treatment. The restrictions noted in the 1986 Update have been abolished or will be abolished in the near future. Foreign firms are allowed to underwrite sterling-denominated securities. Even the discount market, formerly the domain of U.K. firms, was opened wide to foreign firms by the Bank of England in 1988 (although foreign ownership of discount houses predates 1988, as Citibank purchased Secombe, Marshall and Campion in 1985). The lack of interest reflects lackluster profit opportunities in this unique area of U.K. finance.

In the 1986 Update, some concern was expressed about the unequal incidence of the stamp duty, which was seen by some as a hidden market barrier to foreign firms. On "a date late in 1991/1992," the stamp tax on the purchase and sale of securities in the U.K. will be abolished. That includes the 0.5 percent levy on individual share transfers, the 1.5 percent on American depository receipts and the stamp duty reserve tax which applies at the same rates as stamp duty to some share transactions outside the stamp duty net. The abolition of these duties is expected to coincide with the beginning of a paperless trading system under the International Stock Exchange. Until then, the duty continues to apply at existing rates.

Domestic Banking Market

The U.K. is host to one of the most international banking centers in the world. As of February 1990, 530 foreign banks were represented in the U.K., of which 67 were from the U.S.

Origin of Ownership	Branch	Subsidiary	Controlling Stake in Consortium Banks	Representative Office	Total
EC	75	19	-	62	156
Other OECD	35	15	2	28	80
(of which Japan)	(23)	(7)	(2)	(22)	(54)
S.E. Asia	42	9	3	29	83
North America	40	19	5	12	76
(of which U.S.)	(34)	(16)	(5)	(12)	(67)
Other	67	7	8	53	135
TOTAL	259	69	18	184	530

At the end of March 1990, American banks reported total assets and liabilities of 120.7 billion pounds sterling ($203.2 billion), or 10 percent of total footings (i.e., total balance sheet assets or total balance sheet liabilities plus net worth) of all banks in the U.K. British law permits banks to engage in securities business. As a result, several U.S. banks have found it advantageous to organize U.K. banking subsidiaries in addition to their branch operations. Eleven American banks are in this dual status category. Of the 16 American-owned banking subsidiaries in the U.K., 12 have bank parents. Likewise, several U.S. securities firms have organized banking subsidiaries in the U.K. Four of the American-owned banking subsidiaries have security-firm parents. American banking affiliates report no significant national treatment problems in the U.K.

CONCLUSION

In general, foreign firms enjoy full national treatment and expanded business opportunities. Major market and regulatory changes in the U.K. since 1986 have significantly widened the range of business opportunities available to both domestic and foreign firms operating in the securities industry in Britain. The Financial Services Act of 1986 has been implemented in a manner that has provided de facto national treatment to American firms. No bilateral problems have arisen with respect to the reserve reciprocity provisions of the FSA. Foreign firms, which were only beginning to be admitted to the stock exchange in 1986, are now widely represented on the exchange and are members of its executive board. An American is the head of the principal securities self-regulatory agency, the Securities Association. U.K. regulators have taken the lead in establishing bilateral supervisory understandings with the SEC, the CFTC and the U.S. banking authorities. These have facilitated the smooth authorization of U.S. firms to operate in the U.K. consistent with the authorities' supervisory responsibilities under the FSA. Regulation has become more codified, more transparent and more expensive. The opportunities provided in the U.K. have been keenly competitive, particularly since the 1987 market decline. Aggressive expansion by American firms has been followed by some contraction and consolidation over the last two years.

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*U.S. dollar figures calculated at the following rate:

$1 = .5939 pounds sterling (June 1, 1990)

LEGISLATIVE MANDATE FOR 1990 REPORT

The Omnibus Trade and Competitiveness Act of 1988
Subtitle G - Financial Reports

SEC 3601. SHORT TITLE

This subtitle may be cited as the "Financial Reports Act of 1988."

SEC 3602. QUADRENNIAL REPORTS ON FOREIGN TREATMENT OF UNITED STATES FINANCIAL INSTITUTIONS.

Not less frequently than every 4 years, beginning December 1, 1990, the Secretary of the Treasury, in conjunction with the Secretary of State, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Department of Commerce, shall report to the Congress on (1) the foreign countries from which foreign financial services institutions have entered into the business of providing financial services in the United States, (2) the kinds of financial services which are being offered, (3) the extent to which foreign countries deny national treatment to United States banking organizations and securities companies, and (4) the efforts undertaken by the United States to eliminate such discrimination. The report shall focus on those countries in which there are significant denials of national treatment which impact United States financial firms. The report shall also describe the progress of discussions pursuant to section 3603.

SEC 3603. FAIR TRADE IN FINANCIAL SERVICES.

(a) DISCUSSIONS - When advantageous the President or his designee shall conduct discussions with the governments of countries that are major financial centers, aimed at:

(1) ensuring the United States banking organizations and securities companies have access to foreign markets and receive national treatment in those markets;

(2) reducing or eliminating barriers to, and other distortions of, international trade in financial services;

(3) achieving reasonable comparability in the types of financial services permissible for financial service companies; and

(4) developing uniform supervisory standards for banking organizations and securities companies, including uniform capital standards.

(b) CONSULTATION BEFORE DISCUSSIONS. - Before entering into those discussions, the President or his designee shall consult with the committees of jurisdiction in the Senate and the House of Representatives.

(c) RECOMMENDATIONS. - After completing those discussions and after consultation with the committees of jurisdiction, the President shall transmit to the Congress any recommendations that have emerged from those discussions. Any recommendations for changes in United States financial laws or practices shall be accompanied by a description of the changes in foreign financial laws or practices that would accompany action by the Congress, and by an explanation of the benefits that would accrue to the United States from adoption of the recommendations.

(d) CONSTRUCTION OF SECTION - Nothing in this section may be construed as prior approval of any legislation which may be necessary to implement any recommendations resulting from discussions under this section.

Appendix II

Acknowledgments

The preparation of the 1990 National Treatment Study was a much larger undertaking than the original 1979 report and the updates prepared in 1984 and 1986. In addition to the enlarged scope of the report, it differed from earlier ones in that there were no full-time staff members assigned exclusively to its preparation.

The Office of the Comptroller of the Currency (OCC) and the Office of the Assistant Secretary of the Treasury for International Affairs (OASIA) assumed responsibility for the preparation of the entire report and its production. Other departments and agencies that contributed substantially include: the Department of State, particularly officers in overseas posts, the Federal Reserve Board (FRB), the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC) and the Department of Commerce.

The Study Directors made a major effort to focus on significant denials of national treatment and on problems of specific relevance to U.S. financial firms. They also sought to identify progress. Information about denials of national treatment and general treatment of U.S. banking and securities firms in foreign markets was received from a wide range of private sector financial institutions, associations, institutes and from a member of Congress. Some of this information was written, some was provided orally. Foreign financial and monetary officials also reviewed individual market chapters and provided comments. In addition, U.S. diplomatic missions overseas benefited from the input of U.S. financial firms in the foreign markets being described.

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Institute of International Finance
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Securities Industry Association

Charles E. Schumer, Member of Congress

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Study Director - Banking	Study Director - Securities

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